CAPITAL UNDERWRITING

AN ACCOUNT OF THE PRINCIPLES AND PRACTICE OF UNDERWRITING CAPITAL ISSUES, TOGETHER WITH A CRITICAL ANALYSIS OF THE MAIN UNDERWRITING AND SUB-UNDERWRITING AGREEMENTS

BY

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PREFACE

WE are on the eve of a period of great activity in the capital market Memories are short, the 1927–28 boom is all but forgotten How much have we learned since then? Is the coming boom to be a repetition of the last one, with all its misdirected effort and stupid wastefulness?

This book deals with the nerve centre of the capital market—the guarantee provided by underwriting The scandals of 1927–28 resulted from the partial collapse of the guarantee obligation of the Issuing House Unless underwriting is brought out from its secret place, and its meaning and importance made clear to the man in the street, it can safely be predicted that many of the worst characteristics of 1927–28 will soon repeat themselves

I have had to devote considerable attention to the legal side of underwriting—a task approached with diffidence by one who is not a lawyer Fortunately, Mr Walter Smith, whose knowledge of company law and practice, I need hardly say, is unrivalled in the City, has been good enough to read the proofs I take this opportunity of expressing my gratitude to him for his shrewd and helpful criticism

I would remind Mr James Kershaw of a talk we had some years ago, when he brought home to me, by examples from his large experience, the stages in the deterioration of the provisions of Main Underwriting Agreements after 1920

I acknowledge the kindness of everyone I approached for permission to quote—

Of the Controller of H M Stationery Office for

permission to reproduce Extracts from the Report of the Company Law Amendment Committee, 1925–26, and from the Report of the Committee on Finance and Industry

Of the Editors of *The Times*, *The Financial Times*, and *The Financial News* for permission to use the Extracts quoted in Chapters X and XI

Of the Committee of the London Stock Exchange for permission to quote from the Rules of the Stock Exchange in Chapter XIII

Last, but not least, I thank Mr E Saxon Napier for giving me access to his unique collection of newspaper cuttings Mr Napier intended to write this book jointly with me, but, to my regret, the pressure of other interests prevented him from so doing

DAVID FINNIE

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A knowledge of underwriting the concern of every investor

UNTIL recently most people have been content to regard the underwriting of capital issues as exclusively the business of that mass of financial institutions they know vaguely as the money market The underwriting of capital, they have thought, is a matter for experts, and no concern of the ordinary investor They linked it up with insurance, and, as a branch of insurance, it was invested in their minds with the solid attributes of British insurance practice Their faith has been shaken during the past few years Since 1928 they have read the strong pronouncements of High Court Judges, the dry condemnations of Official Receivers, and the fulminations of the Press, denouncing with many voices but one intent the malpractices and failures of capital underwriting In the boom years from 1927 to 1929 the public invested with the comfortable feeling that issues were underwritten and that, therefore, the ventures they were backing started off with ample capital to prove their worth Too late they found that many of these companies, owing to defects

in underwriting, never had a chance, lived long enough only to pay commissions to intermediaries, and died ingloriously in compulsory liquidation in the Courts It is estimated that British investors, largely owing to defective underwriting, lost £70,000,000 in the 1927–29 boom Then came the deluge, from which we are slowly and painfully emerging In the reconstruction that must take place, it is essential that the underwriting of capital issues be put on a proper basis A knowledge of underwriting practice is the immediate concern of all who desire to see England restored to her proper place at the financial head of the nations

The underwriting of issues of capital is, shortly, an agreement by underwriters to take shares or stock or debentures offered to the public if the public do not apply for them The underwriters receive a commission for their services The company making the issue pays this commission as a premium to ensure the success of the issue The underwriters, in order to limit their responsibility or spread their risks, usually sub-underwrite among their friends and clients, but the company making the issue is not a party to the sub-underwriting, the contracts for which are between the underwriters and sub-underwriters only

Underwriting in origin a marine insurance term

The terms "underwriting" and "underwriter" first came into use in connection with marine insurance at the close of the seventeenth century, when the marine policy was beginning to take definite form A ship and its cargo represented a great deal of capital liable to all the risks of trading by sea In those days, when the aggregations of capital were small, the total loss of a well-laden ship might well have strained the resources of any one person The owner therefore sought to pool or share the risk among a number of

insurers A policy was drawn up defining the risk At the foot of the policy there was a schedule, and those who accepted the risk subscribed, or wrote under, or underwrote, their names on the schedule, showing against their names the proportion of the total amount insured for which they agreed to be responsible They were underwriters

At the end of the seventeenth century, those interested in shipping and marine insurance met daily in various coffee houses, and especially at the Coffee House of one, Edward Lloyd, in Tower Street Policies were capable of various interpretations and the perils incident upon a sea voyage were numerous It was found necessary to introduce clauses specifically defining the liability of the underwriters At first marine insurance was an ordinary commercial transaction The owner wishing to insure went to, say, Lloyd's Coffee House, and told the merchants there of the proposed voyage These gentlemen then drew up the policy and underwrote their respective shares As shipping increased and insurance grew more complex, marine insurance developed into a business for experts Brokers were called in to mediate between merchant and underwriter Underwriters began to organize themselves, and "Lloyd's" grew until in time it became the greatest marine insurance institution in the world In 1820, the monopoly of Lloyd's was broken when Parliament granted charters for the incorporation of the London Assurance Corporation and the Royal Exchange Assurance Corporation To-day, of course, there are many insurance companies, underwriting the most varied kinds of risks

It will be seen, then, that underwriting is an insurance term With the coming of the industrial revolution, the introduction of the principle of limited

liability, the rise of Stock Exchanges as an easy method of marketing shares, and the appearance of great companies appealing to the public for capital to cope with large-scale production and distribution, it would have seemed in the natural course of things that underwriting should be extended to cover the risk of failure of an issue of capital to the public

Capital underwriting, although a kind of insurance, is not undertaken by Lloyd's or by the insurance companies

While, however, capital underwriting is an extension of the principle of insurance, it forms no part of insurance practice as generally understood The underwriting of issues of capital is never accepted by insurance companies or by Lloyd's They regard the success or failure of issues of capital as a risk that is not within their sphere Yet underwriters at Lloyd's will insure almost anything else—at a price We have said that Lloyd's has become the greatest marine insurance organization in the world In the 'eighties, under the able lead of pioneers such as Mr Cuthbert Heath, Lloyd's underwriters began to extend their sphere of operations, until to-day there are few branches of financial activity that they do not "cover" Apart from such usual insurances as marine, fire, accident, burglary, employers' liability, and motor-car risks, a football club, for instance, may insure against a fall in takings owing to bad weather at a match, or organizers of a cross-word competition may insure against the receipt of insufficient sixpences or shillings from competitors to cover expenses and prizes There is no end to the risks that some underwriter or other at Lloyd's is prepared to cover But they will have nothing to do with issues of capital

The underwriting organization that Lloyd's has built up for all risks except issues of capital

This is all the more unfortunate when we consider the excellent organization and discipline of Lloyd's Nowadays it is by no means easy to become an underwriter at Lloyd's, for Lloyd's considers itself—perhaps

not unreasonably—the most exclusive organization in London Election is in the hands of the Committee, which examines with the greatest care the financial standing and the status of every candidate The entrance fee is £500 and the annual subscription £30 The candidate must satisfy the Committee that he is worth at least £30,000, and it is made clear to him that, if he is accepted, his liability for any risks underwritten by him or on his behalf is unlimited On admission he has to deposit security for his underwriting liability The deposit is not less than £6,000 It is regulated by the amount of premium income on the business underwritten, and as the volume of business grows, it may have to be increased The Committee insists on the deposit bearing a definite relation to the premium income, or, in other words, to the risks accepted This security is placed in the custody of the Committee, is held by Trustees of whom Lloyd's is one, and is exclusively available for the discharge of underwriting liabilities contracted at Lloyd's In addition, each underwriter must lodge and maintain the sum of £1,000 in what is known as a "Premium Trust Fund"

All insurance business at Lloyd's is done by individual members of the Society The general practice is for several members—usually from three or four to ten or twelve—to form syndicates, in association but not in partnership, which carry on their business through a single agent, who acts and underwrites for the group The agent has a place on the floor at Lloyd's great building in Leadenhall Street, and to his seat there come the brokers proposing business If the agent accepts a risk on behalf of his syndicate, each member of the syndicate is severally liable for his syndicate share That is the reason why, on the back of a Lloyd's policy, can be seen rubber stamps showing the share

taken by each member of the syndicate or syndicates underwriting the risk A risk of any size is usually spread over a number of syndicates A broker with a large risk to place tries to get a well-known syndicate first of all to take a portion With this "lead" he approaches other syndicates until finally he has insured the whole

Each member must furnish annually to the Committee a certificate, in a form laid down by the Board of Trade and certified by a public accountant approved by the Committee, that his underwriting assets and security are sufficient to meet his liabilities, and that his premiums are placed in trust in accordance with the provisions of a deed approved by the Board of Trade The accountant, of course, also provides periodical statements to the member showing the working of the syndicate

The corporate affairs of Lloyd's are managed by the Committee which is elected from and by the general body of members The Committee has a double care—the protection of its members and the protection of policyholders Its eminently sensible and practical regulations are designed with this double object in view

Lloyd's has taken two-and-a-half centuries to build up and perfect its organization An underwriting default is unknown Syndicates have on occasions been badly managed and have had to be wound up, but Lloyd's takes care to see that the policyholders do not suffer

No similar organization for capital underwriters

Unfortunately this excellent organization is not at the service of the government, municipality, or company desirous of insuring against the risk of failure of a loan or capital issue There is no similar organization for underwriters of capital issues An elaborate specialized machinery has been evolved in connection

with foreign loans, and government and municipal issues are well looked after As for the industrial issues, there are underwriters, and underwriting syndicates, many of whom are of the highest reputation and carry out their contracts to the letter, but there have also been many otherwise The latter class have no traditions and are subject to no discipline

Until 1900 capital underwriting not respectable

In view of the popular misconceptions regarding underwriting practice, this is an astonishing state of affairs, but it is by no means the whole story It was only in 1900 that capital underwriting became respectable Until 1900 a company was forbidden by law to pay a premium or commission out of capital for underwriting its shares, and woe betide the unfortunate company and all concerned with it that was found guilty of making any payment for placing or guaranteeing the placing of its shares Listen to Mr Justice Kay's weighty pronouncement in one of the earliest leading cases—*Faure Electric Accumulator Co* (1888), 40 Ch D 154—

> "Payment of what is called brokerage for placing shares is not really payment for work and labour It is a commission—that is, a bonus to A to use his influence to make B, C, and D shareholders Put the simplest case A says to the Directors, 'I know a wealthy man whom I can persuade to take 10,000 of your shares, give me £200 and I will induce him to do so' Would that be a legitimate payment? The practice, so far as it exists, has grown up from the launching of bubble companies which would not be brought out without the aid of speculators who insist on being paid a bonus or commission for their help In the case of an enterprise which is favourably received by the public, not a penny need be spent in this way It is only companies which are unsound,

or at any rate unpopular, which resort to such devices"

The Court decided that the payment of commission on the shares was *ultra vires*, and the directors had to repay the commission with interest at 4 per cent

Even the Companies Act, 1929, avoids the term "underwriting"

Even to this day, not one of the Companies Acts has mentioned the word "underwriting" The Companies Act, 1900, grudgingly legalized to a certain extent the payment of underwriting commission in these words—

> "Upon any offer of shares to the public for subscription it shall be lawful for a company to pay a commission to any person in consideration of his subscribing or agreeing to subscribe, whether absolutely or conditionally, for any shares in the company, or procuring or agreeing to procure subscriptions"

The law's safeguard for the investor is the principle of the minimum subscription

The law has always taken quite another view of the methods by which a public company should ensure that it has sufficient capital for its requirements The legal principle has been the method of minimum subscription In a public issue, the minimum subscription on which the directors may proceed to allotment must be set out in the prospectus, and no allotment of share capital offered to the public may be made unless the amount fixed as the minimum subscription has been subscribed

It does not need much reflection to realize how little distance the legal principle of minimum subscription takes us in solving this problem of ensuring that a company receives, as a result of a public issue of share capital, a sum sufficient for its requirements When the first Companies Act of 1862 laid down the principle

of minimum subscription, it assumed a wise and knowledgeable body of investors who would judge for themselves whether the minimum subscription set out in the Articles of Association of the Company and in the Prospectus was adequate for the purposes of the company, and it gave them what was at best the negative safeguard of refusing to allow the company to allot any of the shares offered unless this minimum amount had been subscribed Legislation has a peculiar effect on the natural man We all, of course, obey the law, but whenever the law touches our pockets, there is a tendency, so strong that economists might well add it to their collection of economic laws, for us to satisfy its minimum requirements only Adam Smith had this in mind when he drafted his canons of taxation We see its operation every day in the application of the Income Tax Acts These Acts set out in the most comprehensive way, both explicitly and implicitly, to define what are profits or income subject to tax A considerable proportion of the time of every professional accountant is remuneratively employed in considering ways and means by which he may compute his clients' profits at the lowest level compatible with an interpretation, as liberal as possible, of the legal rules

An imperfect safeguard

The Companies Acts have proved no exception Whenever a new Act has been promulgated, keen and able minds have at once fastened on it to find the loopholes The sections dealing with minimum subscription were quickly reduced to a farce To form a public company at least seven persons must sign the Memorandum of Association of the Company, and each subscriber must take not less than one share in the Company It is within the memory of all of us that in the years preceding 1929 it had become usual practice

for the Memorandum of Association to be signed by seven persons and no more, the Memorandum or Articles fixed the minimum subscription at seven shares only, that is to say, one share for each person who signed the Memorandum, and the number of shares named in the prospectus as the minimum subscription was seven This practice was considered by many to be a flagrant violation of the spirit of the Companies Acts, and the 1929 Act went a certain distance to put it right by defining legally the minimum subscription If the practice of underwriting had not arisen and if the public had had to depend for their safeguard on the principle of minimum subscription, their position would have been perilous Fortunately, underwriting did come to the rescue of the investor

Necessity and uses of underwriting

Now why is underwriting needed? What are its advantages? We can look at them from four points of view firstly, that of the people selling a business to the public, secondly, that of the intermediary—the issuing house—making the issue, thirdly, that of the public, and fourthly, that of the underwriters

To the vendor

Let us suppose that the old family business of John Smith & Co is being converted into a public company The business has expanded, and there is a bank overdraft, well secured, of £200,000 Two partners, who retired some years ago, left a considerable portion of their capital, say £150,000, in the business In addition, the Company has taken deposits of £50,000 from customers The substantial assets to be sold to the public company are therefore represented to a large extent by a bank overdraft and cash creditors Although Messrs A, B and C, the surviving partners, who are selling the business are prepared to take shares for the whole of their interest, a sum of at least £400,000 is required to clear the assets If Messrs A, B and

C are wise men they certainly will not sign their contracts until they have guarantees that the issue will provide in cash at least this necessary sum of £400,000 The issuing house provides this guarantee through its underwriting contracts

Or suppose there is contemplated an amalgamation between the X Electrical Company, the Y Electrical Company, and the Z Electrical Company A Finance House undertakes the issue on the following terms The X Company is to receive £100,000 in cash and £140,000 in shares, the Y Company is to receive £200,000 in cash and £250,000 in shares, and the Z Company is to receive £75,000 in cash and £140,000 in shares The Finance House has, therefore, to find £375,000 in cash In addition, working capital and extensions to plant, it is estimated, will absorb a further £225,000, and the expenses of the issue are put at £50,000 The total amount of cash required is £650,000 If the public fail to come in, the amalgamation will fall through, the time, trouble, and expense involved will be thrown away, and this failure may well make it impossible to arrange finance for years to come The owners, therefore, demand guarantees from the Finance House that the issue will produce the £650,000 cash required These guarantees the Finance House produces through its underwriting arrangements

To the issuing house

Now let us take the point of view of the Finance or Issuing House Its very existence depends on the success of its issues, they must succeed If the public do not subscribe in the first place, then the underwriters must take up the burden and unload as opportunity occurs through the Stock Exchanges From this point of view, underwriting is an essential part of the machinery of the money market

It is seldom realized how much effort and expense

are entailed in a public issue There are the preliminary investigations of the business by experts, the preparation of the prospectus, the selection of the Board of Directors, the securing of underwriters, the quietly managed Press campaign to prepare the public for the great day, and much besides All these cost money The night before the issue several hundred thousand prospectuses have to be sent out to selected addresses of likely subscribers Printing and postage can easily absorb £2,000 or £3,000 On the morning of the issue the prospectus must be adequately advertised in the Press, and this may cost anything from £3,000 to £10,000 If the issue is, say, £500,000, stamp duty of ½ per cent is £2,500, and there are professional fees and other costs Such expenses are not lightly undertaken Of course, the company (i e the public) will eventually pay them when the issue is subscribed, and the issuing house has probably obtained guarantees for its outlay from the interests on whose behalf the issue is being made, but meantime it has to foot the bill

Then comes the day when the issue is actually made So many things may happen to spoil it No matter how carefully the issue has been made, no matter how sound it appears in the eyes of the promoters, it by no means follows that the public will rush forward with their subscriptions The issuing house may have misjudged the appeal to the investing public The public are as fickle in their investments as in most other matters Gramophones may be the rage, or mines, or oils, or artificial silk, but the favourite type is dropped just as quickly as it was taken up, and the last issues of its kind are unfortunate The successful issuing house may be an expert in psychology, but even Jupiter in high Olympus nodded once, and the expert has been known to make mistakes

In the short interval between the decision to make the issue and the actual offer to the public, much may happen An unexpected rise in the bank rate, a sudden tightness in the money market, a financial scandal, a Press campaign, disturbing news from the Continent, or from the near East, or from South America, or from the United States, an earthquake in Japan—these are a few examples remembered by all of us in the past five years that completely wrecked the public response to perfectly good issues Underwriting has saved the companies, or, at any rate, the underwriting ought to have saved the companies The public may only have subscribed 10 per cent of the issue, the underwriters have made good the rest What would have happened if there had been no underwriting? As the capital required had not been subscribed, the application money would have had to be returned to the public, the issue expenses would be lost, the company might become subject to prejudice and criticism for years, and all this notwithstanding the conviction of all concerned that the business was a thoroughly sound one, and that the issue, but for the unexpected, would have proved a complete success When the issue is underwritten, the underwriters are left to "hold the baby" In many recent cases the baby proved to be a very healthy infant, and in a short space of time the shares or stock were taken from the underwriters through the medium of the Stock Exchange and rose to a premium

To the public

From the point of view of the public, the advantages of underwriting are obvious They are only too aware that the statutory enactments regarding the minimum subscription are at best a sorry safeguard When they see that an issue is well underwritten, they have the assurance that no matter what the response to the issue may be, the company will get its money They

can therefore consider the issue on its merits Their attention need not be diverted by fears and considerations of the kind we have mentioned'

To the underwriter

The point of view of the underwriters is simple They are taking a risk, and they are paid for it If their judgment has been sound, the public will subscribe If the public do not come in, they are left with the whole machinery of the Stock Exchange and its environs to help to dispose of the shares If their judgment has been faulty, and the public neither subscribe to the issue nor do their part when a market in the shares is made on the Exchange, it is unfortunate for the underwriters, but it is the risk every underwriter runs

Even this cursory review of the situation shows us how urgent, how essential, is the need for underwriting issues of capital British insurance has set the standard for the whole world The principles of joint-stock limited liability companies took their rise, or at least their form, in this country Why, then, there has been such determined opposition to extending the insurance principle to issues of capital is a matter deserving close attention When we consider the problem we shall find that in all great industrial countries except England there is a recognized and effective machinery for concentrating the savings of investors, and with those savings supplying the capital needs of industry and trade An integral part of this machinery is a proper underwriting system In this country alone is there no such machinery, and underwriting is haphazard and unorganized An appreciation of the reasons for this state of affairs is essential if we are to understand the problems raised to-day by current underwriting practice We must look for the reasons in the historical development of industry and the money market in England

CHAPTER II

THE PARADOX EXPLAINED

The birth of the joint stock idea

WHEN the Atlantic Ocean instead of the Mediterranean became the sea of commerce, the joint-stock idea was born Professor Pollard, in his *Factors of Modern History*, called Henry the Navigator Henry the Company Promoter To the Venetian merchant trading in the Levant, a voyage that lasted six weeks or two months was a long one His galley was of moderate size and comparatively cheap to run A trading expedition to the East Indies, to America, to the Cape of Good Hope, was another matter The voyage might last any time up to three years, and the cost of fitting out was great The prizes were rich, but the losses were proportionately heavy When the great Trade routes had been opened up, and something approaching regular commerce began to take shape, it was soon found that no one person, not even the King of Spain or the Queen of England, was rich enough to finance an expedition, far less to maintain a steady trade

It soon became apparent that the only possible method was to persuade many people to contribute to a common fund or joint stock, out of which the expedition could be financed The earliest example in England of which we have record is the company of Merchant Adventurers—"The Merchants Adventurers of England, for the discovery of lands, territories, Isles, Dominions, and seigniories unknowen, and not before their late adventure or enterprise, by seas or Navigations, commonly frequented" These early companies believed in giving themselves adequate titles The

Merchant Adventurers were incorporated in the reign of Queen Mary, and had their rights confirmed by Parliament in Queen Elizabeth's reign As Hakluyt said (*The Principal Navigations Voyages Traffiques and Discoveries of the English Nation*, I, 247)

> "It was thought expedient, that a certaine summe of money should publiquely bee collected to serve for the furnishing of so many shippes And lest any private man should bee too much oppressed and charged, a course was taken, that every man willing to be of the societie, should disburse the portion of twentie and five pounds a piece"

The joint stock company

When the Armada had been destroyed, and Drake set out on his great expedition of 1589 to harry the Spanish Main, the venture has been aptly described as a joint-stock speculation in a huge piratical enterprise The holders of shares in the expedition did very well out of them

When regular commerce with distant lands began, however, it was seen that conditions of partnership might be very onerous If a gentleman of Devon or Sussex had a share in a fleet of three ships trading to the Moluccas, and he wished to dispose of it, there were considerable difficulties in the way of transfer It became evident that some form of organization must be created with continuous existence, with transmissible or transferable stock, but without the right to any individual in the association on his own account to deal with the assets of the company or to bind his fellow-members So the joint-stock company came into being When the East India Merchants in 1599 asked for the privilege of incorporation, their plea was that trade with the Indies was so remote that it could not be managed without the privilege of

perpetual succession, without a "joint and united stock"

In the early years of the seventeenth century Bacon could write—

> "I confess I did ever think that trading in companies is most agreeable to the English nation, which wanteth that same general vein of a republic which runneth in the Dutch and serves them instead of a company"

But the privilege of full incorporation was given very reluctantly by the Crown Up to the end of the seventeenth century there were only three chartered joint-stock companies—the East India, the Royal Africa, and the Hudson's Bay Companies The leaven was working, however, and attempts were made to apply the joint-stock principles even to the rudimentary industrial enterprises of the time With the coming of William and Mary, the foundation of the Bank of England, the acknowledgment of a National Debt, and the novel idea that men could lend to the King, receive interest on the loan, and even know that their capital was safe, a new impetus was given to the joint-stock movement

Revolutionary consequences of the acknowledgment of the National Debt

The creation of a National Debt was a reversal of ancient practice English kings from time immemorial had contracted debts, one of the most revolutionary innovations of the Revolution of 1688 was, as Lord Macaulay has said, the practice of honestly paying them In early days, the approach of the Court was the approach of a plague, and men ran to conceal their effects and their persons until the royal plunderer had passed Richard Coeur de Lion responded nobly to the call to arms to deliver the Holy Sepulchre He farmed the revenues, levied taxes on his subjects in

proportion to their wealth, sold titles and royal lands, pawned all his belongings On his return he resumed possession of everything that he had sold on the ground that he had no right to alienate it Henry VIII levied benevolences If the unfortunate sufferer lived frugally for some years thereafter, a further benevolence was claimed, because he must have saved by his frugality, if he maintained his former standard of living, it was obvious that he had been underassessed, and an additional assessment was levied In 1522 Henry VIII made a forced loan of 10 per cent upon all property from £20 to £300, with a higher rate on larger sums Seven years later, Parliament went through the formality of releasing him from any obligation to repay The suppressed monasteries financed the rest of his reign Even Charles II—who took money from France, borrowed from his friends, did anything rather than run the risk of being sent on his travels again—coolly stole £1,328,526 that the goldsmiths had deposited for safe keeping in the Royal Exchequer The arrival of William III marked the beginning of a new era in the history of the monetary world Perhaps the main reason why the Stuarts never came back to the English throne is to be found in the formation of the Bank of England, the beginning of the National Debt, and the acknowledgment, half-hearted though it was, by Parliament that the debt was a national obligation So long as the new regime continued, men felt that their money was moderately secure

Rise of the Stock Exchange

The creation of the National Debt and the foundation of the Bank of England led directly to the rise of the Stock Exchange A rudimentary loan issuing machinery began to develop, and the Stock Exchange took form in Change Alley as the place where the securities representing the loans could be bought or sold The

dealers in Change Alley, or "jobbers" as they were called, soon learnt to combine dealings in the "funds" with dealings in the shares of the joint-stock companies, and a new impulse was given to trade It must be recorded that these first jobbers soon earned a bad name The stock of the East India Company was an early favourite No sooner was it known that one of the India Company's well-laden vessels was on its way than every method was employed to unsettle the market Men were hired to whisper of hurricanes that had sunk the ship, of quicksands that had swallowed her up, of pirates that had captured her, of war that had broken out But the public were avid for speculation, and for investment

Spread of the joint stock movement

Joint-stock companies were formed for all sorts of purposes, and a speculative boom swept through England, culminating in the South Sea Bubble in 1720 The history of the South Sea Company, founded in 1711 to improve public credit, is known to all It was the signal for a host of similar concerns There was no necessity to canvass for money, it was poured into the market Early in 1720 some wags opened an office in Change Alley to receive "Subscriptions for Raising a Million" The office was inundated with subscribers, paying 5s as deposit on every £1,000 they subscribed They asked no questions, they just believed they would make their fortune In the end an advertisement was published that it had only been a trial to see how many fools could be caught in one day, and subscribers would have their money back

Audi et alteram partem

Twenty years' experience of this new-fangled notion that the joint-stock idea, instead of being reserved for stately institutions such as the East India Company, could be used for almost any phase of commercial activity, was enough for the wise men of the day

They came to the conclusion that the joint-stock company was a nuisance The Bubble Act (6 Geo I, c 18) recited that

> "The Persons who contrive or attempt such dangerous and mischievous Undertakings or Projects, under false Pretences of Publick Good, do presume according to their own Devices and Schemes, to open Books for Publick Subscriptions, and draw in many Unwary Persons to subscribe therein towards Raising great Sums of Money, whereupon the Subscribers or Claimants under them do pay small Proportions thereof, and such Proportions in the whole do amount to very large Sums and whereas in many cases the said Undertakers or Subscribers have presumed to Act as if they were Corporate Bodies, and have pretended to make their Shares in Stocks Transferrable or Assignable, without any Legal Authority, either by Act of Parliament or by any Charter from the Crown for so doing "

Final triumph of the joint stock company

The attempt to suppress joint-stock companies proved impossible The legal history of the eighteenth and early nineteenth centuries is strewn with records of judicial decisions restricting the activities of companies The struggle for free transfer was long and bitter Judges denounced the creation of large companies formed by small subscribers, they called them "a lure to the unwary" The continued attempt to limit the liability of members to the amount of their shareholding also roused the judicial ire "A mischievous delusion" was the favourite epithet for the practice But the expansion of trade and the rise of industry were factors too strong for any legal bonds The joint-stock company, a legal person separate from its members, enjoying perpetual succession, with shares

readily transferable and imposing on its members no liability beyond the nominal amount of their shareholding, was the only type of organization that could cope with this new world that was opening out before men's eyes The legislature in 1862 recognized the inevitable, and passed the first Companies Act The principle of limited liability was recognized No royal charter was henceforth necessary for incorporation The formalities required in constituting a company were now light The joint-stock company was to be the normal machinery for the organization of trade and industry

Expanding trade and the Industrial Revolution created a demand for capital such as the world before had never known In the nineteenth century the demand for capital became insistent In practically every country except England, it has been necessary, in order to make the demand for capital effective, to have some intermediate organization that investigates the demand and presents it as a claim to the public, supported by the intermediary's own guarantee Except in England, this function has been performed by the banks In the world outside England it is accepted doctrine that a proper and primary business of a banking system is to promote or arrange the long-term finance of industry and trade In England this is not so British banks resolutely refuse to furnish or to sponsor the provision of capital In England there is no well-defined intermediary The only equivalent we have, and that only during the past half-century or so, is a promoting group that makes the issue and underwrites it With such market machinery, the prospective earning power of any venture is only imperfectly converted into an effective demand for capital The place of the guarantee of the bank is

taken in England by the guarantee of the underwriters The unusual importance of underwriting in England begins to emerge

We must look for the explanation of this state of affairs to the conditions that have governed the supply of capital in this country We were a great commercial nation long before the Industrial Revolution Since the late seventeenth century, with gradually but steadily increasing national wealth, money has been seeking employment In the eighteenth century the "nabobs" brought home great fortunes from India Trade expanded in all directions The twenty years of the Napoleonic wars concentrated practically the whole world trade in the British Empire At the close of the eighteenth century there was the greatest of all Revolutions, the Industrial Revolution, and we had a clear 50 years' start of other nations in the application of machinery to manufacturing processes

At first the units of industry were small, and they were financed on a family basis Most of our great industrial concerns have, or until recently had, family names The small units were extended out of profits, and additional capital was obtained from relatives and friends The great merchants were only too willing to finance any new industry Wages and rents were low, and there was a rapid accumulation of wealth in the hands of the manufacturing class There was always a substantial capital surplus questing promising employment An experienced type of investor came into being As the nineteenth century proceeded, and the industrial unit became larger, there was still no difficulty in finding capital for new or going concerns Public confidence was high The Bank Act of 1844, by its encouragement of cheque currency, had enormously increased the rapidity of circulation of money,

and laid solid the foundations of modern credit The industrial need of capital did not call for the creation of special machinery The legal facilities given to joint-stock companies by the first Companies Act of 1862 at a time of rapidly accumulating wealth in the hands of the manufacturers themselves were enough The organization of a money market depends on general social conditions In England in the nineteenth century the wealth of a section of the population, always looking for profitable employment, enabled the business man to obtain capital from those associated with him in business or from personal friends and relations or through a public issue as safeguarded by the Companies Acts There was no urgent need for an intermediate organization to which the concern requiring capital could go, which would investigate the position, and which, if satisfied, would take steps to see that the capital was provided

In Germany, for instance, circumstances were entirely different In the third quarter of the nineteenth century Germany was poor, the general level of public confidence was low, and England had had a half-century's start in the industrial race The impetus of German expansion came from above rather than from below Its ambitious rulers deliberately set out to create an industrial state The heavy demands for capital were met by the development of the great credit banks Deposits at these banks were relatively small, but their paid-up capital was large Any enterprise requiring capital was investigated by one of these banks, and, if the need were established, the bank sponsored the issue of capital In the first place it probably provided the capital from its own resources, made a market in the shares, and gradually sold them to its own clients and to the public So far as the

enterprise requiring capital was concerned, its anxiety was over when it had satisfied the bank that capital could be profitably employed The bank did the rest

In England, neither the banks nor any other institution performed this function The need for it was not felt This suited the nineteenth-century industrialist A financial intermediary for the provision of capital, if it is to perform its function to the public, demands a certain amount of financial control The British have prided themselves on self-reliance Self-help and *laissez-faire* were the twin gods of Victorian industry and trade The business man used his bank when convenient for short-term finance, but he kept absolute control of his business The great deposit banks were equally pleased with this state of affairs Their predecessors had burned their fingers in the late eighteenth and early nineteenth centuries through entering into partnership with industry When the joint-stock banks came into existence about the middle of the last century, they resolutely refused to have anything to do with long-term finance They developed as banks of deposit Their capital is relatively small compared with their enormous resources These resources consist largely of the deposit of other people's money Any investment of these resources must be of the most liquid nature The three months' bill of exchange, or the overdraft recallable at demand, constitutes the limit to which they are prepared to go in assisting industry and trade Our bankers are prepared to supplement the working capital of a business by bridging the gap between receipts and payments through discounting bills of exchange, or by temporary lending (through advances in the form of loan or overdraft) in cases of seasonal activity and to meet contingencies In either case the banker's first inquiry

is "What security have you to offer?" He conceives it as no part of his function to provide or assist in the provision of the permanent capital of a business In other words, he supplements the capital of a borrower, he does not furnish it The energies of our banking system have been devoted to two great functions—the creation and circulation of the cheque, our real home currency, and of the short-term bill, the London bill, our international currency Long-term and even intermediate finance have been alien to the fundamental conceptions of British banking We have often sighed for a little more spirit of enterprise among our bankers, but we are realizing to-day the enormous value of an impregnable banking system The great banking failures and panics, and the ruin following from the destruction of confidence that we see in certain other countries are at any rate passing us by

Our banks, then, have concerned themselves with the needs of commerce rather than of industry They have paid more attention to short-term and international finance than to the requirements of the home capital market The case has been different in the international sphere There London was the world's greatest money market Foreign governments and municipalities, great transport companies and the like, looked to London not only for short-term but also for long-term finance We were an important commercial nation before the Industrial Revolution In the late eighteenth and in the nineteenth centuries London became the centre for trade between the Continent and the rest of the world, and the great private merchant banking houses settled here and flourished We need only recall such as are active to-day—houses like Rothschilds, Barings, Schroeders, Lazards, Kleinworts, Hambros, Japhets, and so on These private banks

early made themselves responsible for the issue of foreign loans, they were our first issuing houses In fact, if you to-day mention "issuing house" to the elderly City man, he usually assumes that you mean one of the acceptance banks that specialize in foreign issues Nathaniel Meyer Rothschild, who settled in London in 1800, was the first outstanding figure Foreign loans prior to his time had not been popular in England Interest was received abroad, payable in foreign coin, and it was subject not only to the rate of exchange but to the caprice of the monarch to whom the loan had been made Nathaniel Meyer Rothschild introduced the payment of interest in sterling and in England

A foreign government raising a loan in London must have an intermediary, and the obvious intermediary was the merchant bank These banks have created an elaborate specialized machinery for placing foreign issues They take the greatest pains in examining every proposition submitted to them, they vouch for the issue They have an underwriting system that is well-nigh perfect and to which we shall refer later When the prospectus of a loan is published, the public see that it is vouched for by one of these merchant banks as issuing house, they know it is properly underwritten, and they have the assurance that the interests of investors have been and will be protected as far as possible The issuing house keeps a constant watch over the actions of the borrower to see that the security for the loan remains unimpaired When anything goes wrong—if the security is not properly maintained, if remittances are not sent to London in good time, if the borrower does acts that may harm his credit—the issuing house regards it as a duty to do everything it can to put matters straight These duties involve

a great deal of responsibility, labour, and expense, but they are performed unhesitatingly and as a matter of course The merchant bank as issuing house is the intermediate organization that investigates the foreign demand for money, presents that claim to the public supported by its own guarantee, and so makes the demand effective

This function of the merchant bank in regard to foreign loans is, after all, merely an extension to a wider sphere of the principles underlying its very existence as an acceptance bank A farmer in Brazil wants to buy some agricultural machinery in Lincoln Brazil is far from Lincoln The English manufacturer has little or no idea of the financial standing and integrity of his customer The machinery may have to be specially made, it certainly has to be shipped, and the Brazilian has no intention of paying for it until he has had delivery In fact, he may not even be able to pay on delivery Like many another farmer, he may have to wait until his crops are harvested and sold before he is in funds His need for the machinery is very real, but the manufacturer, before he supplies the goods, has to be satisfied that the Brazilian can pay for them To bridge the gap, to make this foreign demand effective, there are the London acceptance banks The farmer, through his own bank in Brazil or otherwise, approaches an acceptance bank in London, satisfies it of his ability to pay, and the acceptance bank informs the manufacturer that, when the goods are ready for dispatch, he should draw a bill of exchange on the bank for the agreed sale price and expenses, such as insurance and freight In due course, the bill, say at three months, comes with the shipping documents to the acceptance bank and the bank accepts the bill The manufacturer can, of course,

discount this bill at once and get cash The machinery is shipped to Brazil, the documents go to the bank's correspondents there, the goods are delivered to the farmer, and three months after the date on which the bill was drawn, in the case we have supposed, the farmer or his Brazilian bank puts the London acceptance bank in funds to meet the bill when its holder, whoever he may now be, presents it for payment The acceptance bank is the intermediary that investigates the foreign demand and makes it effective through its own guarantee

While home industry had for long no need of such an intermediary for the provision of capital, circumstances changed towards the close of the nineteenth century Industry tended to become large-scale and international in scope As the twentieth century drew near, capital issues grew to be much more frequent and on a scale undreamt of 50 years before Largely as a consequence of these tendencies, the ownership and the management of capital became more and more divorced In 1848 John Stuart Mill could note that in England the ownership of capital and the management were usually one As enterprises became larger, however, and appeals to the public for capital more frequent, individual shareholders in public companies had less and less relative power When the founders of a business died, they tended to be replaced as directors by efficient managers rather than by relatives, until to-day the divorce of ownership from management is almost complete

All these factors made it progressively less easy to find new capital for the public company among friends and connections, and an intermediary had to be found who would place the issue before the public But the difficulty of underwriting immediately appeared The

law frowned on underwriting, and without the guarantee that underwriting provides, the embryo issuing house for industrial issues could do little or nothing This situation was rectified by the recognition of underwriting in the 1900 Companies Act That the position to-day, however, leaves much to be desired may be seen from the following extracts from the very interesting Report of the Committee on Finance and Industry (1931), usually known as the Macmillan Report

386 It is all-important to the community that its savings should be invested in the most fruitful and generally useful enterprises offering at home Yet, in general, the individual investor can hardly be supposed to have himself knowledge of much value either as to the profitable character or the security of what is offered to him How easily he can be misled in times of speculative fever by glittering—even tawdry—appearances is proved by the experience of 1928, as the following striking figures will show

In that year the total amount subscribed for capital issues whether of shares or debentures of 284 companies was £117,000,000 At 31st May, 1931, the total market value of these issues as far as ascertainable was £66,000,000 showing a loss of over £50,000,000 or about 47 per cent In fact the public's loss has been greater since many of these shares were no doubt sold by the promoters at a high premium Still more striking, perhaps, 70 of the above companies have already been wound up and the capital of 36 others has no ascertainable value The issues of these 106 companies during that year amounted to nearly £20,000,000

387 That you cannot prevent a fool from his folly is no reason why you should not give a prudent man guidance We believe that our financial machinery is definitely weak in that it fails to give clear guidance to the investor when appeals are made to

him on behalf of home industry When he is investing abroad he has the assistance of long-established issuing houses, whose reputation is world-wide When subscriptions to a foreign issue are invited by means of a public prospectus, it is almost certain that that issue will be vouched for by one of these issuing houses whose name will be evidence that it has been thoroughly examined and the interests of the investors protected as far as possible For the issuing house's issuing credit, which can easily be affected, is involved, and it is very highly to its own interest to make sure that the issue is sound .

388 Contrast this with nearly all home industrial issues There are, it is true, one or two first-class houses in the City which perform for certain first-class companies the same functions as the older issuing houses perform for foreign borrowers In addition these latter are to a limited extent entering the domestic field, though, for the reasons we give later, their direct interest must probably remain limited Again, the advice of stockbrokers, when asked for, may be a safeguard, but it is scarcely sufficient to take the place of the responsibility of a first-class issuing house With these exceptions the public is usually not guided by any institution whose name and reputation it knows For in the main all issues are made in the same way Each of them has in the most prominent position and in much the heaviest type on the prospectus the name of a joint-stock bank—in the great majority of cases one of the "Big Five"—as receiving subscriptions to the issue It is perfectly natural that an inexpert investor, seeing the name of a well-known bank on the prospectus, should believe that the bank in question vouches in some way for the issue But he is mistaken None of the Big Five regard themselves, except in very rare cases, as fathering the issue or in any way responsible for it beyond seeing that the prospectus complies generally with the law, and that the issue is on the face of it respectable None of them would wish the public to assume that they

vouched for the issue and the figures of profits and assets, etc , given in the prospectus, in the same way as the issuing houses vouch for their issues They frequently know the company, through having had banking relations with it over a series of years On the other hand, they may know practically nothing of it The *real* issuer may be the company itself, if it is a strong and good one, or a finance company or syndicate—few large, many small, some good, some indifferent, some bad—and sometimes it is a company or a syndicate got together for the sole purpose of making a particular issue The investor may not realize that the all-important point is not the name of the bank receiving subscriptions but that of the company or syndicate really responsible for the issue, the more doubtful the issue the more likely it is that this name will appear in very modest and retiring print In the case of big, first-class companies, the names of which are a sufficient guarantee in themselves, and which probably issue their own securities, this system is adequate But in most other cases the public is left without a guide, with the results which we have indicated above It would, in our opinion, be an important reform that relations between finance and industry should be so developed that issuing institutions of first-class strength and repute should vouch to the investor more normally and more fully for the intrinsic soundness of the issues made, and that the joint-stock banks should not give the appearance of sponsoring issues so long as in fact their real responsibility is limited to receiving subscriptions In this way the investor would be encouraged to support well-vouched issues and be put on his guard against others

CHAPTER III

FOREIGN PRACTICE

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IN practically all countries except England it is one of the main functions of a banking system to provide or sponsor the provision of the long-term capital for industry The exception in the case of England is explained by the course of her economic and social history in the past two centuries On the Continent the Industrial Revolution started later, and when it came, its development was much more rapid

In Germany it commenced in the 'fifties and 'sixties German company legislation and practice provide for two forms of company promotion, the "successive" and the "simultaneous" The "successive" is much like our English method The promoters appeal direct to the public to invest the capital required But this way of providing a company with capital has never been very successful in Germany, and now it is rare indeed

The credit bank

In the second, or "simultaneous" method, the promoters are one of the credit banks The promoters take over the whole of the capital required and later place it in whole or in part with the public There are two distinct steps in the procedure First of all, the company in need of capital places all the facts before the bank The bank makes a complete investigation, and, if it is satisfied, agrees the amount of the issue and its terms with the company It places one or more of its nominees on the Board of Directors Finally, it takes up the capital required The second step is the issue to the public There may be quite an

interval between the two stages When a firm is converted into a limited liability company, for instance, one business year, must pass and the first directors' report and accounts be published before a quotation for the shares can be obtained on a German Stock Exchange The promoting bank may decide to wait this time or even longer before passing the issue on to the public

The issue to the public is not as a rule made by the promoting bank alone It is usually made by a banking syndicate, of which of course the promoting bank is an important member This syndicate or "Konsortium" of bankers, as it is called, takes over the responsibility for the issue Each member bank binds itself to accept a certain portion of the issue and to pay for its proportion of the shares or stock as required This agreement among the syndicate members is the nearest approach to underwriting as we understand it The syndicate members in fact underwrite the issue

The Konsortium may place the shares in one of several directions Firstly, it may offer them for public subscription at a fixed price Secondly, it may obtain a Stock Exchange quotation and make a market in the shares Thirdly, the members of the syndicate may place the shares among their own customers The third method is usually auxiliary to the first two

The reason for the intervention of the banks may be found partly in the history of German industrial development and partly in the history of German company legislation In the 'fifties and 'sixties, when the Industrial Revolution really began to gather momentum in the countries we now know as Germany, it was obvious that development must be rapid if Germany were not to be left behind in the world race But

Germany was a poor country The private investor as England knew him at the same period was almost non-existent The political rulers of Prussia realized the importance of rapid expansion The demand for capital was insistent How was the demand to be formulated? There was no machinery in existence They created the machinery The great credit banks were founded These banks made the initial investment, and afterwards, when they had shown the way, the public began to come in As wealth accumulated and the investor class increased in numbers, the practice arose of appealing direct to the public This latter method never became the more popular of the two Traditions quickly establish themselves, even in our everchanging modern industrial world The German had acquired the habit of looking to the credit banks to give him a lead After all, his confidence was well founded He had the guarantee that, before the issue, the project had been thoroughly examined by the bank's experts He knew that the underwriting arrangements were wholly in the bank's hands and that, whatever happened, the company would have its capital He knew that the bank had identified itself with the company's future, had its representatives on the Board of Directors, and would look after the market in the shares on the Stock Exchange

Towards the close of the nineteenth century, there were many promotion scandals in Germany as in every other industrial country This new technique of providing industry with capital gave the unscrupulous promoter too many opportunities of making easy money German company legislation, as consolidated in 1896, therefore, regulated strictly the conditions of issue The most important provisions were that—

1 The whole issue must be subscribed within a

period to be stated in the prospectus, and at least 25 per cent must be paid up, before the company came into existence

2 When a private business was converted into a limited liability company there could be no Stock Exchange quotation until one business year had passed, and the first report and balance sheet had been published

3 Dealings in partly-paid shares, except insurance shares, were prohibited

There were other conditions prohibiting the issue of shares under par, limiting promotion profits, and so on The effect of these enactments was to kill the "successive" issue, and to give a monopoly of issues to the credit banks and their allies There was no provision for a minimum subscription as in English law The whole issue had to be subscribed before the company could come into existence Unless the issue was well underwritten, the promoters therefore ran a very grave risk, but organized underwriting was largely in the hands of the credit banks, who did not look kindly on rivals in the field of company promotion There was also the delay of one year after formation before a Stock Exchange quotation could be obtained, and, even on the purely formal side, German company legislation is stricter than ours For instance, an insufficient attendance of members at the opening general meeting of shareholders cancels the incorporation of the company For all these reasons the "successive" issue, or the public issue as we know it in this country, has disappeared in Germany The credit banks led the way in the first instance, and company legislation has driven their competitors out of the market

From our point of view, we may say that Germany has the complete underwriting system The promoting

bank in the first place gives the company making the issue its most effective guarantee by taking up the capital itself In the second place, the members of the issuing Konsortium, or banking syndicate, give a complete guarantee to the promoting bank by taking over their due proportion of the issue The machinery is complete The demand for capital is effectively formulated The company on whose behalf the issue is made gets its capital at once from the promoting bank The public in due course take up the shares from the Konsortium, with the knowledge that the company in which they are investing has been thoroughly investigated by the bankers, and that all legal requirements have been met

One of the most interesting differences between the balance sheet of an English and of a German bank is to be found in the constitution of the investments An English bank's investments consist wholly of gilt-edged stocks and shares in subsidiary banks a German bank's investments include a considerable proportion of shares in associated industrial companies Part of these holdings is permanent, and part is the result of the bank's underwriting operations that are yet to be placed with the public The banks usually retain a certain permanent holding of shares of the industrial companies in which they are interested This gives them influence and prestige

The system has, of course, obvious dangers Unless great care is exercised, the bank tends to become an industrial rather than a financial institution Of course, its permanent holdings, theoretically at any rate, are bought with the bank's own capital A credit bank's capital is, relative to its assets, much greater than that of an English bank But, in times of rapid industrial development, there is always the human tendency to

underwrite as much as possible, and the bank is apt to be left with an undue proportion of its resources tied up in shares of industrial securities In addition, the bank has responsibilities to the public who, relying on the bank's warranty, have subscribed to the issue In difficult times, the banks have to finance these companies, and their resources may become immobilized In the Austrian Credit-Anstalt we have an example of what this can mean In the old Austro-Hungarian Empire, the system that we have described was applied with even more thoroughness than in Germany It is common knowledge how the Credit-Anstalt became immobilized in 1931, how the Bank of England went to its assistance, and how there started that whole course of events that eventually forced England off the Gold Standard

In Belgium there has been the same tendency to close relationship between banks and industry The Société Générale de Belgique, founded in 1822, was perhaps the first joint-stock bank in Europe to adopt a policy involving some degree of control over the various industrial concerns in which it is interested The reasons have been the same as in Germany The Napoleonic Wars left Belgium impoverished There was no substantial class of private investor It was left to the banks to provide industry with capital After the war of 1914–18 the banks were again the only source of floating capital, and in the last decade the Belgian banks have reconstituted Belgian industry It has been a remarkable achievement Just as in Germany, issues of capital have, so to speak, received a banker's warranty The underwriting machine has functioned perfectly In 1930 it was estimated that the Société Génerale and the Banque de Bruxelles between them controlled companies whose total capital

amounted to 10 billion francs, or about one-half the total nominal capital of all Belgian companies In addition they controlled as many as 90 colonial enterprises

Holland

In France and Holland, while there are banks that operate like the English banks, deal only in short-term loans and securities, and regard themselves as deposit banks, there are also general banks with the same functions as the German credit banks They finance industry by long-term credits They frequently underwrite issues for industrial companies and arrange for the disposal of the securities among the investing public

France

It is not too much to say that the capital issue in France is in the hands of the banks France shares with Belgium the distinction of having created the industrial or credit bank The genius of Saint Simon appreciated that industry in its modern developments requires special machinery for the provision of its capital, that the banks of deposit are unsuited to provide such finance, and that institutions must be created for this purpose His disciples, the Pereires, formed in their Crédit Mobilier the first of these institutions

The epidemic of fake underwriting, paper finance, and dummy companies, that swept England in 1928, could not attack France The Code Commerciale safeguards the French investor by provisions similar to the German code For instance, all the capital of a company must be subscribed at the time of incorporation of the company, and a declaration that this has been done must be sworn before a Notary Public Any shares allotted for a consideration other than cash cannot be sold for at least two years from the date of allotment A minimum of 25 per cent of the nominal value of the shares must be subscribed for in cash Immediately half the share capital of a company has

been lost, a general meeting of the shareholders must be called to decide whether the company shall continue to carry on business.

It is odd to reflect from what small causes important effects may flow There is little doubt that one of the main reasons for the continuance of the bank's domination abroad as the placer of capital is to be found in the denomination of shares In England the £1 is the usual unit, and the appeal to the public is made comparatively simple thereby In Germany, the favourite share has been Mks 100, in Holland, 100 fl , in France, 500 frs , and so on The large denomination of shares rather frightened the general investor, especially in the case of the new company The whole business, to the man in the street, savoured rather of a banking business than of one in which he should be directly interested with the company

In the United States also an issuing machinery has been built up between the investor and industry The Macmillan Report gives an excellent short account of the system as follows—

> "It was to the development of American industry in the widest sense that the financial world of New York devoted itself rather than to international finance The great industries and the railroads were affiliated in general to particular banking houses, and in the building up, and in particular in the merging, of most of the great American corporations, some house or bank has played a leading part, with the consequence that the relationship between them has usually remained a close and continuous one It may be said that all industrial issues of well-known companies are sponsored by some responsible issuing institution, the smaller issue by smaller firms, the larger by large firms or large banks In both cases

it is common for a group of issuing institutions to combine in making the issue In every case the names of the issuing institutions appear prominently on the prospectus, so that the public are left in no doubt as to who is sponsoring the issue Taking this responsibility, the issuing institution naturally attempts to keep in close and continuous touch with the company after the issue So far as the large banks in New York, Chicago, and other centres are concerned, the issues in which they are interested are made usually through subsidiary securities companies Moreover, the American banks are closely concerned with industry from another aspect The banks lend either directly or through brokers very large amounts of money to investors and speculators against industrial securities of all kinds The loans of this kind made by reporting member banks are sometimes at least equal to the loans made direct by them to industry For this reason, also, the banks take a great interest in the stock market and in the industrial securities quoted there

"Thus, under a different system, American banks, private and public, perform for American industry substantially the functions that German banks perform for German industry The connection is a looser one, the number of banks competing is far greater, the problem of finding the necessary capital no doubt is much easier, and industry often needs banking assistance far less Yet, at the same time, the American banks engage their issuing credit in the eyes of the public for the soundness of the issues they support, and this very fact leads, as it must always do, to a closer and more intimate association between banks and industry than where no such responsibility is assumed"

The Macmillan Report was issued in June, 1931 Even then the shock of the Austrian Credit-Anstalt failure had thrown up the weakness of the credit-bank system, 1932 saw the German banking crisis become acute, largely for the same reason—the immobilization of resources through the close connection of banks with the long-term finance of industry There was brewing also in 1932 the storm in American banking circles that finally broke in March, 1933 One of the first acts of President Roosevelt was to insist that American banks confine themselves to the activities of deposit banks, and dissociate themselves from their subsidiary securities companies whose business was to sponsor capital issues While we must admit that foreign practice provides machinery much superior in some ways to our own for the supply of capital to industry, it should be recognized that this machinery has not altogether stood the strain of the present world depression In some countries, it has definitely broken down Our friends abroad will have to modify their systems in the light of the experience of the past few years

Our own great deposit banks have come through the crisis remarkably well, and the reason is to be found in the mobility of their resources They have eschewed the sponsoring of capital issues because it might entail the locking up of funds Depositors, they hold, have confidence in our banks because they know that, no matter how immediate may be their demands, these demands can always be met The deposits are invested in short-term bills, in short-dated government stocks, and in overdrafts recallable at demand, they are not tied up in large holdings of industrial securities

Insurance companies and underwriters at Lloyd's have avoided capital issues for the same reason

Insurance companies will take a line of sub-underwriting as part of the management of their investment funds, but they will not enter into a Main Underwriting Agreement as part of their insurance business The risk involves the possibility of locking up funds for too long a period

CHAPTER IV

THE STATUTORY ASPECT OF UNDERWRITING BEFORE 1900

UNDERWRITING in England has had a stiff fight for recognition The word is not found in any of the Companies Acts It does not even appear in the Companies Act, 1929 An underwriting contract is an ordinary civil contract The forms that it assumes—guarantee agreements, sub-underwriting letters, and so forth—have grown out of the needs that the contract is designed to meet They have been influenced by a long series of legal decisions spread over a wide and diverse field, but so far they have not been the subject of statutory enactment During the last 80 years, Parliament, like the legislatures of every other country, has found it necessary to regulate strictly the manner and substance of industry's appeal to the public for capital The British Parliament, however, has not considered underwriting as an essential and integral part of company promotion and expansion It has relied on the principle of the minimum subscription

Until the beginning of this century underwriting was not respectable In the first chapter, Mr Justice Kay's dictum in the well-known *Faure Electric Accumulator* (1888) *Case* was quoted • Even that mild approach to underwriting, the payment of brokerage for placing shares, called down his wrath

> "The practice," he said, "so far as it exists, has grown up from the launching of bubble companies which would not be brought out without the aid of speculators who insist on being paid a bonus or

> commission for their help In the case of an enterprise which is favourably received by the public, not a penny need be spent in this way It is only companies which are unsound, or at any rate unpopular, which resort to such devices "

What a unique commentary on the economic and financial life of the latter half of the nineteenth century ! It breathes the spirit of an England that has passed away for ever, an England confident, secure and self-sufficient, an England incapable of imagining any challenge to her material pre-eminence

In another famous case, *Lydney and Wigpool Iron Ore Company* v *Bird*, 33 Ch D 85, Lord Justice Lindley, one of the great names of company law, discussed the principle of underwriting in his judgment—

> "It appears to us wholly wrong," he said, "to make the company pay for the issue of its own shares No part of the capital of the company could be properly so applied "

Payment of underwriting commission out of capital *extra vires*

In reading the reported nineteenth century cases involving underwriting, the outstanding impression is the suspicious attitude of the Courts to the payment by anybody of any kind of commission for procuring or for placing capital The Court seemed to take the view that underwriting commission, or even brokerage for placing shares, was a bribe and was suspect When it was a matter of a company paying such commission out of capital, the practice was definitely illegal and the Courts made short shrift of anyone guilty of the heinous offence If a case were brought to the attention of the Courts, the directors who authorized payment of the commission were compelled to refund the amount to the company out of their own pockets A company

might incur very heavy charges for advertising an issue of its shares, but although the aim of such expenditure was the same as that of underwriting, the Court placed no difficulties in the way of a company paying for advertising out of capital Authorities, such as Sir Frederick Palmer, writing in the last decade of the nineteenth century, found it difficult to understand why the Court regarded underwriting commission as so objectionable and differentiated it from any other kind of commission They pointed out that the inability of a company to pay underwriting commission out of its capital led to much mischief It was directly responsible for the practice of issuing founders' shares It frequently compelled companies to raise capital by way of debentures or debenture stock instead of by shares, and, above all, it provided promoters with a good excuse for demanding an excessive price for their services to cover the risk and expenses of underwriting

The legal basis for the attitude of the Court was the implication of the Companies Act of 1862 that a company could not issue shares at a discount Even in the 1862 Act there was no statement that shares must not be issued at a discount, but the Court from the first held, as a strict rule of company law, that it was of the very essence of the spirit of the Acts that shares should not be issued at a discount We have indicated the struggle of the joint-stock principle coupled with limited liability for recognition When a man bought a £1 share, he must pay for it, or the share was not fully paid When he had paid for his £1 share, although he was a member of the company, he had no further liability in respect of that share If the £1 had not been fully paid, the balance was liable to be called up any time at the discretion of the directors

With this principle in mind the Court would tolerate nothing that savoured, however indirectly, of issuing shares at a discount

Until the 1929 Act this was a cardinal feature of English company legislation On 31st October, 1929, the eve of the coming into force of the 1929 Act, there appeared in *The Times* a benedictory letter from the veteran Lord Wrenbury, whose well-known book *Buckley on Companies*, was first published in 1870 But Lord Wrenbury could not refrain from concluding—

> "It has never fallen to me to record any departure from the original principle, except in one matter, which I confess I regret, and that is the permission to issue shares at a discount This is the only retrograde step in principle which I recall since 1862"

The reason for the disfavour with which the Court regarded what otherwise might have been looked on as the legitimate attempts of underwriters to surmount this difficulty is to be sought in the history of the raising of capital in the nineteenth century Owing to the rapidly accumulating wealth of the manufacturing classes, the need of capital for industrial purposes did not call for special machinery There was always a large surplus of capital looking for promising employment, and capital for the development of industry was, as a rule, found among the friends and connections of those associated with the enterprise

Towards the close of the nineteenth century, it became more and more apparent that underwriting commission and brokerage for placing shares were becoming an essential part of the machinery of the money market In *Metropolitan Coal Consumers' Association* v *Scrimgeour* (1895), the Court of Appeal held that the payment

of a small commission of 2½ per cent to brokers for their services was within the directors' powers Commenting on this case, Sir Frederick Palmer, in the 1895 edition of his *Company Precedents*, wrote—

> "If this be the law, it would seem that to pay a moderate underwriting commission out of capital must also be *intra vires* It is to be hoped that the decision will stand, but it is well known that some of the most eminent lawyers of the Chancery Bar, including one who is now a Lord of Appeal, have repeatedly advised that a commission could not be paid out of capital for placing or underwriting shares "

We can say, therefore, that until the 1900 Act, a company, even if it were authorized by its Memorandum and Articles, could not legally pay out of its capital a commission for underwriting or placing shares The payment of such commission was regarded as equivalent to issuing shares at a discount

While this prohibition checked the growth of underwriting, there was nothing to prevent a company paying an underwriting commission so long as the payment was not made out of capital It could, for instance, pay the commission out of profits, including share premiums carried to reserve It could give as underwriting consideration a call at par or at a premium on unissued shares It could allot founders' shares to those agreeing to subscribe for ordinary shares In addition, there was nothing in the Companies Acts to prevent the issue of debentures at a discount, for the debenture in its modern form was unknown in the 'sixties, when the 1862 Act was promulgated Any reasonable underwriting commission could therefore be paid out of capital in connection with the issue of debentures or debenture stock

Recognition by Companies Act, 1900

The Companies Act, 1900, changed the whole aspect of underwriting For the first time in England underwriting was given status The 1900 Act made possible the payment of underwriting commission by a company out of its own capital when it made an issue of shares to the public This was only the first step on the way that Parliament later had to travel, but it was tremendously important By 1900 it was plain that underwriting had become an essential part of company finance, both from the point of view of the company requiring capital and of the investor supplying it The most obvious necessity for underwriting is in the case of the new public company making its first appeal to the general body of investors, and, naturally, the parties to the underwriting contract should be the company and the underwriters When there is an intermediary between the two, trouble, or rather expense, begins The intermediary demands payment for his services, and as capital issues are for large amounts, even a small commission means a substantial sum of money A new company has no profits out of which to pay the underwriters, their commission must come out of capital Before 1900, therefore, a new company making a share issue could not enter directly into an underwriting agreement Underwriting, however, was in many cases absolutely necessary It could only be accomplished if the law were evaded An intermediary of some kind had to be employed, and he exacted payment commensurate with the service he was rendering the company To a generation familiar with American "bootleggers" this has a familiar ring The inevitable consequence was a long series of promotion scandals

The attitude of the Courts to the practice of underwriting seriously impaired the very principle of

company legislation—that it should be a scheme of law which benefits investors by enabling them to pool their resources and employ them in trade and industry with the advantage of limited liability, and benefits trade and industry in that it puts at their disposal sums that might otherwise be less productively employed In the closing years of the nineteenth century, at the very time when other countries were perfecting the machinery, through banks or otherwise, that would bring capital and trade, money and brains together, the natural development in this direction of the English money market was arrested by the legal prohibition of underwriting The guarantee furnished by underwriting is an essential part of any effective machinery that concentrates the savings of the people and with those savings supplies the capital needs of industry and trade Without underwriting there can be no intermediate organization that investigates industry's demand for capital and presents that demand, supported by its own guarantee, to the public The prohibition of underwriting prevented the growth in England of the issuing house for home industry

In the long run the law gives statutory authority to established trade usage or custom or necessity The 1900 Act recognized the inevitable The recognition was only partial, however, and it was not until 1908 that underwriting came into its own The rise of issuing houses commenced at once, but the war of 1914–18 intervened Peace found us in a new world The pre-war trend of industry towards trusts and combines and of the distribution trades towards amalgamations and multiple-shop systems was accentuated Trade and industry had everywhere become large-scale in size and international in scope To meet the new conditions our whole industrial system needed to be overhauled

and re-equipped The rehabilitation required enormous sums of capital We still had greater stores of wealth than any other country in the world, but we were less well equipped than almost any other country with the machinery that would formulate industry's demand, make it effective, and present it to those who could supply the capital

CHAPTER V

THE STATUTORY ASPECT OF UNDERWRITING AFTER 1900

THE Companies Act, 1900, legalized for the first time the payment of underwriting commission out of capital, but the relative section carefully stipulated that such payment was only lawful upon an offer of shares for public subscription At the same time, it expressly prohibited all payments or allotments of shares by way of commission, whether direct or indirect, other than those sanctioned by the section

Companies Act, 1900, Sect 8

The Section (Companies Act, 1900, Section 8), ran

(1) Upon any offer of shares to the public for subscription it shall be lawful for a company to pay a commission to any person in consideration of his subscribing or agreeing to subscribe, whether absolutely or conditionally, for any shares in the company, or procuring or agreeing to procure subscriptions, whether absolute or conditional, for any shares in the company if the payment of the commission and the amount or rate per cent of the commission paid or agreed to be paid are respectively authorized by the Articles of Association and disclosed in the prospectus, and the commission paid or agreed to be paid does not exceed the amount or rate so authorized

(2) Save as aforesaid, no company shall apply any of its shares or capital money either directly or indirectly in payment of any commission, discount, or allowance, to any person in consideration of his subscribing or agreeing to subscribe, whether absolutely or conditionally, for any shares of the company, or procuring or agreeing to procure subscriptions, whether absolute or conditional, for any shares in the company, whether the shares or money

be so applied by being added to the purchase money of any property acquired by the company or to the contract price of any work to be executed for the company, or the money be paid out of the nominal purchase money or contract price, or otherwise

(3) But nothing in this section shall affect the power of any company to pay such brokerage as it has heretofore been lawful for a company to pay

By one sweep the section altered the whole status of underwriting Up to 1900, underwriting had been a hole-in-the-corner business The company requiring capital could not contract directly with the underwriters, the underwriting arrangements were made by third parties, usually promoters or vendors, and, as we have seen, this gave rise to malpractices The Companies Act of 1900 permitted for the first time a company, prior to offering shares for public subscription, to contract direct with the underwriters In fact, it reversed previous practice completely, for it deprived vendors or promoters of any right to pay underwriting commission, and so ensured that all underwriting contracts must be made direct between the company and the underwriters This was in line with the many legal decisions designed to protect companies from promoters who followed the common practice in the latter half of the nineteenth century of obtaining a secret commission by adding a sum to the agreed purchase price of the assets sold to the company

Section 8 of the Companies Act, 1900, was fundamental, but in practice it was found that the restrictions imposed by it were too severe

The offer of shares had to be for *public subscription* before the payment of underwriting commission was legal Obviously the payment of commission by a private company was ruled out It is a statutory condition of the constitution of a private limited company

that shares must not be offered for public subscription But what was the position when a public company made a share issue to its own members, or where a promoter made an offer to a few friends, or where in a reconstruction a liquidator offered shares in the new company to the members of the old company? These are three common instances where underwriting can be valuable, and the legality of each was tested in the Courts before the close of 1901 In all three cases the Courts held that such offers were not offers to the public and that payment of underwriting commission in such cases was not within the capacity of the company

The 1900 Act prohibited the payment of commission except as sanctioned in Sect 8 This prevented vendors or promoters from paying underwriting commission There had certainly been many abuses in the past through vendors or promoters paying underwriting commission, but these abuses had arisen largely because the payments had to be concealed Now that their legality was recognized, many people failed to see the harm of continuing the old practice, convenient as it was in certain cases, so long as payment of the commission by vendors or promoters was a cash payment properly disclosed

Sect 8 of the Companies Act, 1907, extended the scope of the 1900 Act and remedied these objections by permitting commission to be paid even when no offer was made to the public, and by allowing vendors and promoters to pay commission out of funds coming to them from the company The provisions of the 1907 Act were incorporated in the Companies Consolidation Act, 1908

To make the 1908 position clear, the relative sections of the 1900 and the 1908 Acts are set out below in

Companies Act, 1908, Sect 89

parallel columns The additions made by the 1908 Act are in heavy type

COMPANIES ACT, 1900

Section 8

(1) Upon any offer of shares to the public for subscription it shall be lawful for a company to pay a commission to any person in consideration of his subscribing or agreeing to subscribe, whether absolutely or conditionally, for any shares in the company, or procuring or agreeing to procure subscriptions, whether absolute or conditional, for any shares in the company if the payment of the commission and the amount or rate per cent of the commission paid or agreed to be paid are respectively authorized by the Articles of Association and disclosed in the prospectus, and the commission paid or agreed to be paid does not exceed the amount or rate so authorized

COMPANIES ACT, 1908

Section 89

(1) It shall be lawful for a company to pay a commission to any person in consideration of his subscribing or agreeing to subscribe, whether absolutely or conditionally, for any shares in the company, or procuring or agreeing to procure subscriptions, whether absolute or conditional, for any shares in the company, if the payment of the commission is authorized by the Articles, and the commission paid or agreed to be paid does not exceed the amount or rate so authorized, and if the amount or rate per cent of the commission paid or agreed to be paid is—

(*a*) In the case of shares offered to the public for subscription, disclosed in the prospectus, or

(*b*) In the case of shares not offered to the public for subscription, disclosed in the statement in lieu of prospectus, or in a statement in the prescribed form signed in like manner as a statement in lieu of prospectus and filed with the registrar of companies, and, where a circular or notice, not being a prospectus, inviting subscriptions for the shares is issued, also disclosed in that circular or notice

(2) Save as aforesaid, no company shall apply any of its shares or capital money either directly or indirectly in payment of any commission, discount, or allowance, to any person in consideration of his subscribing or agreeing to subscribe, whether absolutely or conditionally, for any shares of the company, or procuring or agreeing to procure subscriptions, whether absolute or conditional, for any shares in the company, whether the shares or money be so applied by being added to the purchase money of any property acquired by the company or to the contract price of any work to be executed for the company, or the money be paid out of the nominal purchase money or contract price, or otherwise

(2) [Exactly the same as opposite]

(3) But nothing in this section shall affect the power of any company to pay such brokerage as it has heretofore been lawful for a company to pay

(3) Nothing in this section shall affect the power of any company to pay such brokerage as it has heretofore been lawful for a company to pay, and a vendor to, promoter of, or other person who receives payment in money or shares from, a company shall have and shall be deemed always to have had power to apply any part of the money or shares so received in payment of any commission, the payment of which, if made directly by the company, would have been legal under this section

The final position as a result of these statutes was (1) That a company could pay a commission of any amount by way of underwriting if payment of the commission and the rate paid were authorized by the Articles of Association, (2) that underwriting commission could be paid, not only in the case of an offer of shares to the public, but when an offer of further shares was made to members, or when shares were offered to old members by a liquidator, or when shares were offered semi-privately by a promoter to a few friends, or, finally, where the company was a private company.

The 1907 and 1908 Acts marked the utmost swing of the pendulum in the statutory permission to pay underwriting commission It will be remembered that the nineteenth-century objections to the payment of underwriting commission arose from the fear that such a commission was tantamount to the issue of shares at a discount The 1900 Act permitted companies to pay underwriting commission out of capital in the case of a public issue only, and the public were safeguarded by the stipulation that the amount of the underwriting commission must be disclosed in the advertised Prospectus The Acts of 1907 and 1908 extended the payment of underwriting commission to all issues of capital whether advertised or not The only conditions were that the commission should be authorized by the Articles, and typical Articles, even of the greatest companies, gave 25 per cent as a maximum commission In less important companies the rate was sometimes larger, and the effect was precisely what the nineteenth-century Judges had feared, for, irrespective of the authority by which the payment of the commission was clothed, the result was that in numerous cases shares were, in fact,

issued at a substantial discount An underwriting commission of 50 per cent has not been unknown

The 1929 Act has redressed the excess swing of the pendulum The maximum underwriting commission payable is now limited to 10 per cent Put shortly, the effect of the 1929 Act is that any company, public or private, can pay for the underwriting of its shares— Companies Act, 1929

If the payment is a commission,
If it is authorized by the Articles of Association,
If it does not exceed 10 per cent,
If, in the case of a public company, there is disclosure of the rate in the Prospectus or Statement in Lieu of Prospectus

Section 43, the relative section of the 1929 Act, deserves detailed consideration Changes from or additions to the 1908 Act are in *italics*

Commissions and Discounts

Sect 43 (1) It shall be lawful for a company to pay a commission to any person in consideration of his subscribing or agreeing to subscribe, whether absolutely or conditionally, for any shares in the company, or procuring or agreeing to procure subscriptions, whether absolute or conditional, for any shares in the company if— Sect 43 (1)

(*a*) The payment of the commission is authorized by the Articles, and

(*b*) The commission paid or agreed to be paid *does not exceed* 10 *per cent of the price at which the shares are issued or the amount or rate authorized by the Articles, whichever is the less*, and

(*c*) The amount or rate per cent of the commission paid or agreed to be paid is

(i) In the case of shares offered to the public for subscription, disclosed in the prospectus, or

(ii) In the case of shares not offered to the public for subscription, disclosed in the statement in lieu of prospectus, or in a statement in the prescribed form signed in like manner as a statement in lieu of prospectus and delivered before the payment of the commission to the Registrar of Companies for registration, and, where a circular or notice, not being a prospectus, inviting subscription for the shares is issued, also disclosed in that circular or notice, and

(*d*) *The number of shares which persons have agreed for a commission to subscribe absolutely is disclosed in manner aforesaid*

The words "absolutely or conditionally" in the opening sentence of the sub-section cover underwriting practice Underwriting may be either "firm" or "conditional" When underwriting is "firm," the underwriter subscribes, or agrees to subscribe, for shares whether the issue proves to be a success or not The trust companies, for instance, usually underwrite "firm," either wholly or in part, when the issue is one that would provide a suitable holding for their portfolios To them "firm" underwriting is a method of acquiring shares they like at a discount If the issue goes well, they receive a preferential allotment as "firm" underwriters If the issue does not go well, they still receive allotment in full, but they have the underwriting commission to set off against any capital loss that may ensue if the shares go to a discount on the Stock Exchange By the new provision of sub-section 1 (*d*), the number of shares that underwriters take "firm," or in the words of the Act "absolute," must be disclosed

This information should very properly be at the disposal of the potential investor

"Conditional" subscription is the more usual form of underwriting The underwriters guarantee that they will take up the shares for which the public do not subscribe

The restriction of the maximum underwriting commission to 10 per cent in sub-section 1 (*b*) was a much-needed reform It struck at one of the greatest abuses of company promotion in the 1926–28 period A powerful representative committee called the Company Law Amendment Committee sat in 1925 and 1926 to consider alterations that should be made in company law They heard much evidence on underwriting, but the only recommendation they made was in regard to the rate of commission, in these words—

"*F* UNDERWRITING COMMISSION

44 "At present the only limit on the amount of underwriting commission is to be found in the company's Articles of Association, and cases not infrequently occur where a company is empowered to pay underwriting commission up to 50 per cent or even more This has enabled companies in effect to issue shares at a heavy discount and is in our opinion in other respects undesirable

"RECOMMENDATION

45 "We recommend that a limit should be placed on the amount payable for underwriting commission so as to make it a genuine 'commission' and we suggest 10 per cent on the nominal value of the shares underwritten"

The amount or rate per cent of the commission must be disclosed in the Prospectus, or Statement in Lieu of

Prospectus, or circular or notice inviting subscription for shares In the leading case of *Dominion of Canada General Trading and Investment Syndicate* v *Brigstocke* (1911), 2 K B 648, it was held that, if a director paid money out of a company's funds by way of commission when the payment was not disclosed, the company could recover the amount from him The section lays down that the rate or amount of the commission must be shown, it does not definitely state that particulars of the underwriting contracts are to be disclosed The dates of and parties to the underwriting contracts between the company and the Main Underwriters, and particulars of the interest of any director in any underwriting contracts, are, however, required to be stated by the Fourth Schedule to the Companies Act, 1929, to which we refer later

The opening words of the section make it clear that the Act authorizes the payment of underwriting commission by all companies, whether private or public The public issue is not the only means by which a company raises capital Where only a small amount of capital is required, application may be made to a limited circle The issue may be one that appeals to a specialized class of investors The promoter may find the money he wants among friends, relations, or clients Any case of this kind is covered by the section

Sect 43 (2)

(2) Save as aforesaid, no company shall apply any of its shares or capital money either directly or indirectly in payment of any commission, discount, or allowance, to any person in consideration of his subscribing or agreeing to subscribe, whether absolutely or conditionally, for any shares of the company, or procuring or agreeing to procure subscriptions, whether absolute or conditional, for any shares in the company, whether the shares or money be so applied by being added to

the purchase money of any property acquired by the company or to the contract price of any work to be executed for the company, or the money be paid out of the nominal purchase money or contract price, or otherwise

Sub-section 2 prohibits the application of any of a company's shares or capital money, either directly or indirectly, in payment of underwriting commission except under the conditions laid down in sub-section 1 The words "either directly or indirectly" have special reference to the practice, before the 1900 Act, when the payment of underwriting commission by a company was not legal, of providing the means to pay such commission by adding an amount to the agreed purchase price of the assets acquired by the company Underwriting was often necessary, the company was not allowed to pay a commission, the vendor was put in funds to pay the commission by receiving, say, £115,000 instead of £100,000 for the factory he was selling to the company Evasions of this kind, of course, always had abuses, and, now that underwriting commission is legalized the old practice is prohibited

It will be noted that the sub-section only deals with the payment of commission out of capital The words are "Save as aforesaid, no company shall apply any of its shares or capital money" A company has always had the right of paying underwriting commission out of profits, or, if it has the necessary power in its Articles, out of reserve Payment of commission out of profits or reserves is subject to none of the restrictions laid down by the Companies Acts This is as it should be A company with accumulated profits is presumably equipped with a competent Board of Directors who are able to judge the proper amount of underwriting commission that should be paid under

such circumstances The law is chary of interfering with the powers of a company in dealing with its profits The law, so far as underwriting commission is concerned, deals only with payments out of capital

The section also does not prevent a company giving to its underwriters as their commission or payment an option to take up shares at par or above par This proposition is not so self-evident, and to establish it the leading case of *Hilder* v *Dexter* (1902) (A C 474), finally settled in the House of Lords, should be considered

When the 1900 Act was passed, an influential body of opinion held that the corresponding section in that Act prevented the giving of a call for further shares at par or at a premium to underwriters as consideration or part consideration The United Gold Coast Mining Properties, Ltd , was incorporated in December, 1900, with a capital of £200,000 divided into 200,000 shares of £1 each In January, 1901, the Directors decided to issue one-sixth, or 33,333, of these shares They offered them, not to the public, but to fourteen persons, of whom Mr Hilder was one, and Mr Hilder was allotted 6,975 For each share allotted, he was given the option for one year from 31d January, 1901, to take up at par another ordinary share of £1, and if the option were exercised, he had a further option to take up still another ordinary share at par during two years from 3rd January, 1901 In July, 1901, the £1 shares were changing hands at 57s 6d , and Mr Hilder gave the company notice that he exercised his option Mr Dexter, a shareholder of the company, promptly brought an action against Mi Hilder and the company, seeking a declaration that the transaction was an illegal one The lower Court found for Mr Dexter Mr Hilder appealed, but the Court of Appeal confirmed that the transaction was illegal Mr Hilder then took

the case to the House of Lords There the decisions of the lower Courts were reversed, and it was held that the giving of the option was not an application of shares or capital money, either directly or indirectly, in payment of a commission, Mr Hilder was entitled to exercise his option

Lord Davey's judgment is illuminating—

"The first words to be construed are 'apply any of its shares or capital money' I think that these words naturally mean apply its capital, either in the form of shares before issue, when they may be described as potential capital, or in the form of money derived from the issue of its shares 'In payment of any commission, discount, or allowance' I think this means payment by the company The words 'discount or allowance' seem to mean the same thing, namely, a rebate on what would justly be due from the subscriber on his shares The advantage which the appellant will derive from the exercise of his option is certainly not a 'discount or allowance,' because he will have to pay 20s in the pound for every share Nor is it, in my opinion, a commission paid by the Company, for the Company will not part with any portion of its capital which is received by it intact, or indeed with any moneys belonging to it But the words relied on are 'either directly or indirectly,' and the argument seems to be that the Company, by engaging to allot shares at par to the shareholder at a future date, is applying or using its shares in such a manner as to give him a possible benefit at the expense of the Company in this sense, that it forgoes the chance of issuing them at a premium With regard to the latter point, it may or it may not be at the expense of the Company I am not aware of any law which obliges a company

to issue its shares above par because they are saleable at a premium in the market It depends on the circumstances of each case whether it will be prudent or even possible to do so, and it is a question for the directors to decide But the point which, in my opinion, is alone material for the present is that the benefit to the shareholder from being able to sell his shares at a premium is not obtained by him at the expense of the Company's capital The prohibited application of the shares may be direct by allotting them as fully or partly paid up to the person underwriting the shares, or by allotting them in some other way with the intention that they shall ultimately find their way to such person or be applied in payment of his commission

"My Lords, it may be that in some particular case a contract such as that which your Lordships have before you would be open to impeachment as improvident, or an abuse, or in excess of the powers of the management committed to the directors In this case this question is as to the powers of the Company itself, and not as to the due exercise of the directors' powers I have come to the conclusion from a consideration of the language of Sect 8 subsection 2, that the prohibition therein contained extends only to the application, direct or indirect, of the Company's capital in payment of a commission by the Company, and the transaction impeached in this case is not within it"

The Earl of Halsbury, L C , as he had drafted the section of the 1900 Act referred to, did not give judgment, but he said—

"I heartily concur in the judgment which my noble and learned friends have arrived at"

The decision was unanimous

(3) Nothing in this section shall affect the power of any company to pay such brokerage as it has heretofore been lawful for a company to pay Sect 43 (3)

In most cases nowadays, custom insists upon the employment of an agent, and when an issue is made agents perform a useful function The two commonest types of agents of course, in this connection, are stockbrokers and banks They bring an issue to the attention of their clients by the distribution of prospectuses They stamp their name on the application form, and if the application is accepted, they are paid a brokerage for their service Brokerage is quite different from underwriting commission The broker in no way guarantees subscriptions, his function is merely to bring the shares to the notice of others Objection was taken to brokerage, of course, but in the closing years of the nineteenth century the practice was recognized in the Courts In the leading case of *Metropolitan Coal Consumers' Association* v *Scrimgeour* (1895), the Court of Appeal, as we have seen, held that a brokerage of 2½ per cent was legal This decision has stood, and brokerage up to 2½ per cent is usual

(4) A vendor to, promoter of, or other person who receives payment in money or shares from, a company shall have and shall be deemed always to have had power to apply any part of the money or shares so received in payment of any commission, the payment of which, if made directly by the company, would have been legal under this section Sect 43 (4)

This provision was first made in the 1907 Act and gave a much-needed relief to vendors or promoters The 1900 Act enabled underwriting commission to be

paid only by the company, and, at the same time, put an end to the old custom of vendors or promoters increasing the purchase price of the assets by a sum sufficient to pay for underwriting In practice, however, it is often highly convenient that the vendors or promoters should arrange and pay for underwriting Sometimes, for instance, a company buys a property or undertaking, and in the purchase contract reserves the right to cancel the transaction unless a specified number of shares are underwritten or sub-underwritten within a certain period To ensure the carrying out of the contract it is obviously in the interest of the vendor or promoter that he should get shares underwritten On the other hand, the vendor or promoter has not a free hand The commission he pays must be such as would have been legal if the company had paid it directly For instance, it can in no circumstance exceed 10 per cent

> (5) If default is made in complying with the provisions of this section relating to the delivery to the Registrar of the statement in the prescribed form, the company and every officer of the company who is in default shall be liable to a fine not exceeding twenty-five pounds

For the first time in company legislation, the 1929 Act has laid down a penalty in connection with underwriting A fine of £25 may be exacted if the rate or amount of underwriting commission is not inserted in the statement that must be lodged with the Registrar of Joint-stock Companies at the time of every issue of capital

The whole section emphasizes the necessity of making the public fully aware of the amount or rate per cent

of the underwriting commission The object of the promoter is to make the Prospectus as attractive as possible, the object of the legislature is to prevent the public from being misled The statutory provisions attempt to ensure that there shall be the fullest possible disclosure of the nature of the offer to the public, and of the profits that promoters, vendors, directors, brokers, and underwriters will reap from it The public ought to know, in the first place, what they are putting their money into, and, in the second place, how the money will be spent

UNDERWRITING AND THE PROSPECTUS

The particulars that require to be shown in the Prospectus are grouped together in the Fourth Schedule to the 1929 Act The clauses in the Fourth Schedule that affect underwriters and underwriting commission are as follows—

FOURTH SCHEDULE

PART I

MATTERS REQUIRED TO BE STATED IN PROSPECTUS

10 *The amount, if any, paid within the two preceding years, or payable, as commission* (but not including commission to sub-underwriters) *for subscribing or agreeing to subscribe, or procuring or agreeing to procure subscriptions, for any shares in, or debentures of, the company, or the rate of any such commission*

This repeats the provisions of Sect 43 of the Act, but, in addition, the public are to be told the rate or amount of any commission that may have been paid in the two preceding years The shrewd investor will draw his own conclusions if, for instance, he observes that the company has had to contract to pay its

underwriters a higher rate of commission in the issue he is considering than in issues made a year or so previously

13 *The dates of and parties to every material contract, not being a contract entered into in the ordinary course of the business carried on or intended to be carried on by the company or a contract entered into more than two years before the date of issue of the prospectus, and a reasonable time and place at which any such material contract or a copy thereof may be inspected*

Section 43 of the Act stipulates only that the rate or amount of underwriting commission must be disclosed, but it will be seen that para 13 requires the date of the Main Underwriting contracts and the names of the underwriters to be shown

15 *Full particulars of the nature and extent of the interest, if any, of every director in the promotion of, or in the property proposed to be acquired by, the company, or, where the interest of such a director consists in being a partner in a firm, the nature and extent of the interest of the firm, with a statement of all sums paid or agreed to be paid to him or to the firm in cash or shares or otherwise by any person either to induce him to become, or to qualify him as, a director, or otherwise for services rendered by him or by the firm in connection with the promotion or formation of the company*

This clause ensures that any director who has underwritten must disclose his interest in the underwriting

Particular attention should, however, be directed to the emphasized parenthesis of sub-section 10, which states that sub-underwriting commission need not be

shown in the Prospectus Inferentially, no information need be given in regard to sub-underwriting contracts

This raises a most important question The Act of 1900, when it stipulated that a company issuing shares to the public could pay underwriting commission out of capital on condition that the contract, as a material contract, should be disclosed in the public Prospectus, contemplated the position where underwriters were principals and guaranteed the issue In fact, however, as we shall see more fully in the following chapters, the underwriters with whom the company contracts have in the course of the present century, through the rise of the practice of contracting-out their obligations to sub-underwriters, become less and less principals and more and more of the nature of brokers We shall notice the gradual deterioration in the provisions of the Main Underwriting contracts which has given rise to the scandalous state of affairs revealed in the aftermath of the 1928 boom In 1929 seldom a day passed in which the financial Press did not report strong comments by the Courts or by the Board of Trade on the collapse of companies through the failure of sub-underwriters to fulfil their obligations

When the Company Law Amendment Committee took evidence on the proposed changes in the law that eventually materialized in the 1929 Act, the late Senior Official Receiver, Mr H C Burgess, strongly urged that, to prevent underwriting by irresponsible syndicates, particulars of *all* underwriting contracts, with the names, addresses, and amounts underwritten, should be stated in a prominent manner in the Prospectus It was common knowledge that the Main Underwriting contract was often made by syndicates with only a nominal capital Mr Burgess also pointed out the practice where one man controlled a number

of interlocking companies, and through his control used these to underwrite shares issued by one or other of the group Members of the Committee objected that the proposals made by Mr Burgess were impracticable because they would entail the publication of hundreds of names Mr Burgess then suggested that a method might be found by which the names could be certified, but the Commission did not put forward any recommendations In the result, the legal position is, therefore, that only the Main Underwriting contract is treated as material in the Prospectus, although in practice it may be set off by hundreds of sub-contracts No disclosure need be made of the capital even of the Main Underwriters, or of who their sub-underwriters are or of the funds they possess To prevent the scandals to which we have been so accustomed within the past few years, we must apparently look to methods other than statutory enactment

UNDERWRITING COMMISSION IN BALANCE SHEET AND ANNUAL RETURN

The amount of underwriting commission paid must be disclosed in the balance sheet and in the annual summary of a company The relative sections of the 1929 Act are—

Commissions and Discounts

Sect 44 (1) Where a company has paid any sums by way of commission in respect of any shares or debentures, or allowed any sums by way of discount in respect of any debentures, the total amount so paid or allowed, or so much thereof as has not been written off, shall be stated in every balance sheet of the company until the whole amount thereof has been written off

(2) If default is made in complying with this section,

the company and every officer of the company who is in default shall be liable to a default fine

Annual Return

Sect 108 (3) The return must also state the address of the registered office of the company, and must contain a summary distinguishing between shares issued for cash and shares issued as fully or partly paid up otherwise than in cash, and specifying the following particulars—

(*f*) The total amount of the sums, if any, paid by way of commission in respect of any shares or debentures

These sensible provisions repeat corresponding sections of the 1908 Act, except that Sect 44 (2) of the 1929 Act, as part of the general process of tightening up the administration of company law, authorizes the levying of a fine if underwriting commission is not shown on the face of the balance sheet

THE UNDERWRITING OF DEBENTURE ISSUES

It will have been observed that Sect 43 does not require the disclosure of commission paid for underwriting debentures The section confines itself to the issue of shares Sects 44 and 108, however, cover debenture issues They state that underwriting commission in respect of debentures must be shown on the balance sheet and in the annual return The Fourth Schedule to the Companies Act, 1929, which sets out the matters required to be stated in a Prospectus (para 10 on page 67), also enacts that underwriting commission on debentures, paid or payable within two years preceding the issue, is to be shown in the Prospectus The Fifth Schedule to the Companies Act, 1929, gives the form of Statement in Lieu of Prospectus to be delivered to the Registrar by a

company which does not issue a Prospectus The statement in lieu contains the provision—

Amount, if any, paid or payable as commission for subscribing or agreeing to subscribe or procuring or agreeing to procure subscriptions for any shares or debentures in the Company, or	Amount paid £ ,, payable £
Rate of the commission	Rate per cent

In effect, therefore, the 1929 Act has brought debenture issues into line with share issues, except that there is no limit to the rate of underwriting commission that may be paid in connection with a debenture issue

SUMMARY

The law as it stands regarding underwriting commission may be summarized shortly as follows—

1 A company, if it be authorized by its Articles, may pay out of capital a commission not exceeding 10 per cent for underwriting shares in its capital

2 A company that agrees to pay such commission may pay it by way of the allotment of paid-up shares or debentures

3 A vendor or promoter may pay a commission out of money coming to him from the company provided he discloses the payment and the Articles allow it

4 A company may pay underwriting commission out of undivided profits without the restrictions referred to above

5 A company may out of capital or profits pay for underwriting debentures or shares in any other company owned by it

6 A company may give an option or call on shares as consideration for underwriting either shares, debentures, or other securities of the company

7 Except as above, a company may not directly or indirectly pay any underwriting commissions for placing its capital

CHAPTER VI

THE MAIN UNDERWRITING AGREEMENT

The underwriting contract not regulated by the Companies Acts

ALTHOUGH underwriting is an essential part of the machinery of raising capital, we have noted that the word is not used in any of the Companies Acts Our legislators have had to give legal sanction to the practice by authorizing payment of the commission on conditions, but they still fight shy of referring to underwriting by name It is no matter of surprise, therefore, that the Companies Acts preserve silence as to the form or nature of the underwriting agreement

The statutory provisions are directed to limiting the rate of commission that may be paid out of capital and to ensuring full and proper disclosure in Prospectus and balance sheet of the amount of commission paid or agreed to be paid for "procuring or agreeing to procure subscriptions" for shares Beyond these points the Companies Acts leave the arrangement of underwriting contracts to those who make them Provided that the Articles of a company permit payments out of capital for underwriting shares, that the rate of commission does not exceed 10 per cent of the nominal value of the shares, and that proper disclosure of the payment is made, the vendor or promoter or company entering into an agreement for underwriting is left a fairly free hand Beyond applying the ordinary law of contract to any particular transaction the law does not help further

A civil contract with two main lines of development

The underwriting agreement has gradually taken form to meet the needs of the money market, and there have been many legal decisions defining its scope and power. It is an ordinary civil contract, but every

effort has been made to give certainty to its parts, and the Court has always regarded the substance of the contract rather than its form There have been two main lines of development On the one hand, the contract is now expressed as irrevocable and has acquired many of the characteristics of the power of attorney, and on the other hand the practice has grown of underwriters passing on part of their obligations to sub-underwriters In this and the succeeding chapter, we shall be concerned mainly with the development of irrevocability and power of attorney, Chapters VIII and IX will trace the growth and influence of sub-underwriting

As one would expect, the forms of the agreement have changed correspondingly To illustrate the principles involved, we give an example of perhaps the best form of Main Underwriting Agreement in use in current practice for industrial issues

AN AGREEMENT made the day of 19
BETWEEN Limited, whose registered office is situate at in the County of (hereinafter called "the Company") of the one part and whose registered office is situate at in (hereinafter called "the Underwriters") of the other part

WHEREAS—

(1) The Company is incorporated under the Companies Act, 1929, with a nominal capital of £ divided into shares of each,

(2) The Company is proposing to offer the whole of the shares in its capital for public subscription at par,

(3) A preliminary draft of the Prospectus offering

the said shares for public subscription has been prepared and signed for identification by or on behalf of the parties hereto, but it is contemplated that such draft may be altered in some respects before it is finally settled and delivered for registration to the Registrar of Companies,

(4) The expression "the said Prospectus" as hereinafter used in these presents means, unless the context forbids, the said Prospectus as finally settled and delivered for registration to the Registrar of Companies,

(5) In anticipation of this Agreement being entered into, the Underwriters have handed to the Company their cheque for £ , being the deposit of per share payable on application for the shares hereby underwritten by the Underwriters

NOW IT IS HEREBY AGREED as follows—

I For the consideration hereinafter stated and subject as hereinafter mentioned, the Underwriters hereby underwrite the subscription of of the said shares of the Company on the terms of the said Prospectus, and shall lodge with the Bank as the Company's Bankers, before the day on which the said Prospectus is first advertised, applications by themselves and by sub-underwriters approved by the said Bankers, for all the shares hereby underwritten, together, in the case of sub-underwriters' applications, with the sub-underwriters' cheques for payment of the deposit of per share payable on application for the shares sub-underwritten by them The shares sub-underwritten and for which sub-underwriters' applications approved by the said Bankers are so deposited shall total at least shares

II If on or before the closing of the Subscription List as specified in the said Prospectus not less than the whole of the said shares shall have been *bona fide* applied for by the public, excluding applications withdrawn before allotment or rejected by the directors of the Company as unsatisfactory, then no allotment, except in respect of firm applications, is to be made to the Underwriters or sub-underwriters in respect of their applications for shares

III If within such time as aforesaid less than the whole of the said shares are applied for by the public, excluding such applications as aforesaid, then the applications received shall go in relief *pro tanto* of the sub-underwriters and the Underwriters, who shall be allotted the residue only of the said shares not so applied for by the public, and for this purpose the Underwriters are to rank as sub-underwriters in respect of any part of the said shares as shall not be sub-underwritten as aforesaid. Notwithstanding such allotment, the Underwriters shall be responsible for and they hereby guarantee to the Company the due and punctual payment by all sub-underwriters to whom allotments are made of the application and allotment moneys payable on the shares allotted to them

IV The Underwriters' said cheque for £ shall not be presented by the Company for payment unless and until an allotment has been made to the Underwriters or the sub-underwriters or any of them on their underwriting or sub-underwriting applications, and some application or allotment moneys on any of the shares so allotted are unpaid at the expiration of 48 hours from notice of such allotment being given to the Underwriters, and the

cheque of each sub-underwriter accompanying his sub-underwriting application shall not be presented for payment unless and until an allotment shall have been made to such sub-underwriter on his said application, and some application or allotment moneys on the shares so allotted remain unpaid at the expiration of 48 hours after notice of such allotment shall have been given to such sub-underwriter

V In consideration of and subject to the Underwriters duly carrying out the terms of this Contract, and paying or procuring to be paid all application and allotment moneys payable by the Underwriters or any sub-underwriters on any shares allotted to them, the Company will pay to the Underwriters in cash an underwriting commission of per cent and an overriding commission of per cent upon the issue price of the shares hereby underwritten by them, such commission to be paid within seven days after the allotment of the shares hereby underwritten Provided that, if an allotment is made to the Underwriters or any sub-underwriters, such commission is not to be payable until the application and allotment moneys payable in respect of the shares so allotted are paid, and so that such commission may be applied by the Company in or towards payment of such moneys

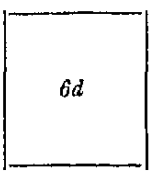
VI The Underwriters hereby irrevocably authorize the Company and each of its Directors for the time being to put in, sign, and complete on their behalf, in the event of their failing themselves so to do, an application or applications in respect of the said shares hereby underwritten or any part thereof so as to make the same effective applications and to hand the same to the Company, and further hereby irrevocably authorize each of such Directors on their

behalf to conclude an agreement with the Company for an allotment to them pursuant to any such application And this Contract and such applications as aforesaid shall be irrevocable on the part of the Underwriters notwithstanding any purported withdrawal on their part or purported repudiation of their responsibility hereunder or under the said applications and shall empower the Directors of the Company to allot to them the number of shares, if any, which they become liable to have allotted to them hereunder and to enter their names in the Register of Shareholders, and the Underwriters undertake forthwith after notice of any such allotment to them to pay to the Company the sums payable on application and allotment for the shares so allotted

VII This Agreement shall be void unless the said Prospectus is issued on or before the day of 19

VIII The approval of the Underwriters shall be required to any alteration in the provisions of the said draft Prospectus

IN WITNESS whereof, etc



A Main Underwriting Agreement of this kind is made between the Company on whose behalf the issue is taking place and the Underwriters The Main Underwriters guarantee the issue They pass on their obligation or part of it to sub-underwriters, but there is no privity of contract between the sub-underwriters and the Company If the sub-underwriters fail to meet their obligations, the Company looks to the Main Underwriters, in terms of the Agreement, to make good the deficiency Paragraph III is specific The Main

Underwriters, for the part of the risk they have retained, rank equally with the sub-underwriters in accepting allotment of the residue of shares not applied for by the public, but "notwithstanding such allotment, the Underwriters shall be responsible for and they hereby guarantee to the Company the due and punctual payment by all sub-underwriters, to whom allotments are made of the application and allotment moneys payable on the shares allotted to them" Again, under Paragraph V, the underwriting commission is payable "in consideration of and subject to the Underwriters duly carrying out the terms of this Contract, and paying or procuring to be paid all application and allotment moneys payable by the Underwriters or any sub-underwriters on any shares allotted to them" The Agreement is a Guarantee Contract The principals are the Main Underwriters and the Company The sub-underwriters are not parties to it

It will be observed that the Agreement has many of the elements of a power of attorney and that it is expressed as being irrevocable

Paragraph VI is very wide If the Underwriters fail to hand in applications in terms of the Underwriting Agreement, the Company is authorized to apply for the shares in the names and on behalf of the Underwriters If the applications put in by the Underwriters are unsigned or otherwise incomplete, the Company is given power to sign and complete them This covers such contingencies, for instance, as the application forms being undated, or the date of the Prospectus being omitted An application for shares must be in proper form and specific in all material points, or the applicant may repudiate the allotment on the ground that the application was defective The Company is given the right to amend applications put in by

Underwriters to ensure that all legal requirements are fulfilled

Whether the applications are made by the Underwriters or by the Company on behalf of the Underwriters, they cannot be withdrawn or repudiated They are irrevocable, and the authority to the Company to apply in the names of the Underwriters if the Underwriters fail to apply is likewise irrevocable In addition, each of the Directors of the Company is irrevocably authorized to accept allotment on behalf of the Underwriters pursuant to such applications, and to enter the names of the Underwriters in the Register of Members The Underwriters, on their part, undertake, immediately on receiving notice of allotment, to pay the Company the sums due on application and allotment If they fail to do so, the cheque handed by them to the Company on or before the signing of the Agreement shall, under Paragraph IV, be presented by the Company for payment The circle is therefore complete

A moment's reflection will show how necessary these powers are An underwriting contract is an insurance contract, covering an immediate and specific risk—the making of an issue of capital The whole future of a company may well depend on the validity of the underwriting contract If the insurer can cancel or withdraw or repudiate the insurance, or if he is able to evade the contract by taking advantage of the many legal technicalities governing applications and allotments of shares, the Underwriting Agreement is hardly worth the paper it is written on Underwriting is an onerous contract, and it is unfortunately true that the history of underwriting practice is to a large extent a history of the ways and means by which Underwriters of unsuccessful issues have sought to evade their liabilities

Prior to the 1900 Act, when underwriting was still under a cloud, a certain class of Underwriters, when an issue went badly, refused to apply for the shares they had underwritten If A agrees with B to underwrite and A refuses to apply for the shares, then prima facie B cannot apply in A's name To get over the difficulty the custom arose of B making it a condition of the contract that, in the event of A failing to apply, B could do so in A's name and on his behalf The practice then, as to a large extent now, was that Underwriters' cheques were not presented until allotment A man usually underwrites because he thinks the prospects of the issue are good and hopes that his cheque will never be called on The Underwriters therefore had a powerful weapon If the issue went badly, or if they thought it might go badly, or if they merely changed their minds about the proposition, they could stop their cheques The issue was finally fought out in the Courts, and the leading case, *Hannan's Empress Gold Mining and Development Co , Ltd* (1896), 2 Ch 643, usually called *Carmichael's case*, is of fundamental importance

Hannan's Empress Gold Mining and Development Co , Ltd , was formed by Mr C B Phillips in February, 1896, to buy a mining property from him for £145,000 The company had a nominal capital of £175,000 in £1 shares, and the purchase price to be paid was £58,333 in fully paid shares, £30,000 in cash, and £56,667 in cash or shares On 21st February, 1896, Mr Carmichael signed an underwriting contract in the form of a letter addressed to Mr Phillips as follows—

> "I agree, for the consideration below stated, to subscribe for 1,000 shares of the above issue, and to pay for the same on the conditions named in the prospectus, or any modification thereof, or of

the title of the Company, or the directors or officers, so long as the capital of the Company and the purchase price of the property are not altered, and I hereby enclose my application for such shares and a cheque for 2s 6d per share deposit in respect of such shares, which deposit I authorize and request you to pay over to the above-named Company, and I undertake to pay the further moneys payable in respect of any shares I have to take up under the terms of this contract

If, on or before the public issue of the prospectus, there are 60,000 shares of the above issue *bona fide* and duly applied for by the public, then no allotment is to be made to me in respect of this agreement, and my application and the said deposit is to be forthwith returned to me by the said Company If less than 60,000 shares are applied for by the public, then I am only to be allotted my proportion of the deficiency between the amount so subscribed for by the public and such 60,000 shares, *pro rata* with any other persons who have signed or may sign underwriting contracts in connection with the above issue

If on the public issue of the prospectus, and before the closing of the list, I deliver to you applications for shares from responsible persons to your satisfaction, such applications shall go primarily in relief of my obligation under this contract

In either case, I am to receive from you a commission of $7\frac{1}{2}$ per cent in cash and $7\frac{1}{2}$ per cent in fully-paid shares of the said Company upon the total shares hereby underwritten by me within 14 days after the completion of the purchase by the above Company, if the whole of such 60,000 shares are applied for by the public, but in the event of the public not applying for the whole of such 60,000

shares, then such commission is to be payable by you within 14 days after payment by me to the Company of the allotment-money in respect of my proportion of the deficiency of such shares, or the completion of the purchase by the above Company, whichever event shall be last, and I authorize you, if you think fit so to do, to apply my said commission or any part thereof in payment to the Company of or on account of the said allotment moneys

I further agree that this agreement and my said application shall be irrevocable on my part, and shall, notwithstanding any withdrawal on my part or any repudiation of my responsibility hereunder or thereunder, be sufficient to authorize and empower you to make any further or other application on my behalf, and also be sufficient to authorize and empower the directors of the Company to allot to me the beforementioned shares, and to enter my name on the Register of Members in respect thereof"

Mr Carmichael signed this letter addressed to Mr Phillips, the promoter, and the promoter by letter accepted The Company was duly incorporated, and the subscription list was advertised to open on 27th March, 1896, and close on 30th March On 27th March, Mr Carmichael, who had sent his application with the underwriting letter, stopped the cheque for the deposit On 30th March, he wrote to the promoter and to the secretary of the Company repudiating the agreement On 2nd April the promoter applied on behalf of Mr Carmichael for 980 shares, the number that, as a result of the issue, he was bound to take up The Company allotted these shares and put Mr Carmichael on the Register of Members Mr Carmichael applied to the Court to have his name removed from the Register

The Court held that Mr Carmichael was not entitled to have his name removed from the Register, for the authority given in the underwriting contract was an authority coupled with an interest and was, therefore, not revocable Where there is a contract for valuable consideration giving to one of the parties to the contract an authority, the other party cannot put an end to the authority by repudiating it An underwriting contract has valuable consideration in the commission, and the authority it gives to apply for shares or otherwise cannot be revoked In these respects the underwriting contract acts as a power of attorney

The two principles of irrevocability and power of attorney are the distinguishing characteristics of the Underwriting Agreement It took many years to establish them, but now that they are established, the Underwriting Agreement is a powerful and efficient document

CHAPTER VII

THE MAIN UNDERWRITING AGREEMENT—ANALYSIS OF PROVISIONS

THE great principles of irrevocability and power of attorney are fundamental to the Underwriting Agreement In addition, the parties to underwriting contracts have used all their endeavours to give certainty to the terms of the contract, and the Courts have co-operated by looking at the substance of the contract rather than its form At the same time, they have definitely rejected attempts to import into Underwriting Agreements implied conditions that might restrict or weaken the express terms of the contract In the past twenty-five years, underwriting contracts have become clear-cut and definite Loopholes have been stopped up and vague terms avoided

Types of Main Agreement

There have been many forms of Underwriting Agreements, but in the last decade the types in common use have tended to become standardized There are still considerable variations in practice At one end of the scale, for instance, we have Messrs Mullens, Marshall & Co., the Government Brokers, whose underwriting agreement is expressed in a few lines, or Rothschilds, whose usual agreement is merely a letter in the following tenor—

> "We agree to underwrite the above issue on the lines of the enclosed prospectus at a commission of per cent "

In view of the reputation of the Government Brokers and of a few houses like the Rothschilds, these informal Agreements are enough They do not even mention sub-underwriters Of course, such Underwriters pass on

a substantial part of their obligation, but they need scarcely fear that their sub-underwriters will default It is rightly considered an honour to be on such sub-underwriting lists although, in the past four years of financial stringency, it has been an honour that some people would willingly have forgone If a sub-underwriter defaulted, he would be struck off the list, and his credit would suffer in every direction In the unlikely event of a default, the Underwriters, of course, would shoulder the responsibility at once The sub-underwriters on the lists of such houses are, however, unlikely to default Relying on the reputation of their principals, they take what is offered In fact, these principals do not so much offer sub-underwriting as allot it The process is, in a way, reminiscent of the eighteenth century days when the houses responsible for public issues dispensed their favours among the Court, the nobility, Members of Parliament, and faithful City friends, who made a handsome profit when dealings in the issues opened on the Exchange

These houses, however, rarely touch the industrial issue, which is the one that mainly concerns us The history of industrial issues in this country, as we have seen, has not been an altogether happy one, and it is to the Underwriting Agreement in this connection that attention is directed The Agreement for a share issue is nowadays substantially on the lines of the example given on page 75 In Chapter X we give a slightly different form used by some issuing houses, but it will be seen that the two differ very little in essentials The final standardization of the Main Agreement is an aim greatly to be desired In all other branches of insurance, standard forms of policies have been evolved Almost every word and phrase of these policies has been legally defined Their meaning

is reasonably sure Any deviation from the standard form is clearly shown on the face of the policy There have been so many legal decisions on the nature, form, and contents of the Underwriting Contract, and there is such substantial agreement on these matters among issuing houses, solicitors, business men, banks, and accountants, that it should not now be a task of very great difficulty to devise a standard form As it is, there is, perhaps, no branch of City practice that is wrapped in such obscurity Main Underwriting Agreements are kept carefully locked up in the safes of City solicitors and of issuing houses Their secrets are jealously guarded The sub-underwriting letter goes to so many people that its form is widely known, but it would be a hardy sub-underwriter, even in these days, who dared to ask for inspection of the Main Agreement The only occasions when the contents of Main Underwriting Agreements have been divulged have been in the course of legal disputes, when Agreements or portions of them have been read out in Court It is submitted that this is not a healthy state of affairs, and that the sooner a standard Agreement is settled and published, the better for capital issues generally

The Agreement given on page 75 we consider to be a good Agreement Its main provisions deserve closer examination

The Agreement a direct contract between company and underwriters

AN AGREEMENT made the day of 19 , BETWEEN Limited, whose registered office is situate at in the County of (hereinafter called " the Company ") of the one part and whose registered office is situate at in (hereinafter called " the Underwriters ") of the other part

WHEREAS—

(1) The Company is incorporated under the Companies Act, 1929, with a nominal capital of £ divided into shares of each,

The Agreement is made between the Company and the Underwriters The sub-underwriters are not parties to it

The closest investigations have been made by the issuing house before the Agreement is prepared When affairs have become so far advanced, it is usual in the case of a new company for the issuing house to insist that the company be registered It has not been unknown, however, that a promoter had to satisfy his principals that underwriting was secured before they would incur the expense of registration He had to produce an underwriting contract, but obviously a company not yet in existence cannot be a party to an agreement The difficulty is surmounted by appointing a trustee for the proposed company, and the Agreement is made between the trustee and the Underwriters The clause given above would, in such a case, require to be modified correspondingly The rest of the Agreement stands, but at the end there would be a provision on the following lines—

> "The Trustee is to be at liberty on behalf of the Underwriters to concur with the Company in making a contract under which the Company is to take the place of the Trustee for the purposes hereof, and if such contract is not duly made before the publication of the prospectus (or some other date or time to be determined) the Underwriters are to stand free from all obligations hereunder"

(2) The Company is proposing to offer the whole of the shares in its capital for public subscription at par,

This is the widest case, where a company is offering the whole of its capital for public subscription, and refers, of course, only to a new company

(3) A preliminary draft of the Prospectus offering the said shares for public subscription has been prepared and signed for identification by or on behalf of the parties hereto, but it is contemplated that such draft may be altered in some respects before it is finally settled and delivered for registration to the Registrar of Companies,

(4) The expression "the said Prospectus" as hereinafter used in these presents means, unless the context forbids, the said Prospectus as finally settled and delivered for registration to the Registrar of Companies

Para VIII The approval of the Underwriters shall be required to any alteration in the provisions of the said draft Prospectus

One of the commonest methods by which Underwriters used to evade their obligations was the plea I agreed to underwrite on the basis of the draft Prospectus you gave me The draft has been altered without my consent, the basis of the Agreement has therefore been changed, and I repudiate the contract While an Underwriter stands in a less favourable position than an ordinary applicant for shares as regards relief on the grounds of defects in the Prospectus, there were nevertheless many instances in the early days of this century when Underwriters successfully repudiated their contracts on these grounds It was unfortunately not uncommon for Underwriters, when they saw that an issue had gone badly, simply to refuse to fulfil their bargain Underwriting had just recently become respectable It had not fully emerged from the shadows

Defaulting Underwriters relied on the reluctance of companies to sue them owing to the delays and publicity involved For these reasons, it became customary to draft the clause regarding the Prospectus in as general terms as possible, or at any rate with ample provision for modification The widest possible clause is somewhat on the following terms—

> "The obligation of the Underwriters hereunder is to hold good notwithstanding any variation between the draft prospectus submitted to them, as above referred to, and the prospectus as finally settled and published, provided that the amount of the capital of the company, namely, £ , divided into shares of £1 each is not altered "

The more usual clauses are, however, those given above The draft Prospectus submitted to the Underwriters is signed for identity by the Underwriters, and alterations to it must have their consent, which, on the other hand, may not be unreasonably withheld There is not usually much trouble in regard to alterations in the Prospectus subsequent to the signing of the Agreement Both parties to the Agreement are by that time too deeply involved, and it is right that any alterations be mutually agreed upon

The Courts, however, as we have emphasized, look to the substance of the contract They will not, for instance, hold the Underwriters or sub-underwriters bound if there is some material change made in the objects of the Company The venture to be launched must be substantially the venture described in the draft Prospectus submitted to the Underwriters, it must not be a new venture Even in this latter case, however, if it could be proved that the Underwriters entered into the contract relying on the names of the directors

only, the principle of irrevocability applies and there is no relief

(5) In anticipation of this Agreement being entered into, the Underwriters have handed to the Company their cheque for £ , being the deposit of per share payable on application for the shares hereby underwritten by the Underwriters

Para IV The Underwriters' said cheque for £ shall not be presented by the Company for payment unless and until an allotment has been made to the Underwriters or the sub-underwriters or any of them on their underwriting or sub-underwriting applications, and some application or allotment moneys on any of the shares so allotted are unpaid at the expiration of 48 hours from notice of such allotment being given to the Underwriters, and the cheque of each sub-underwriter accompanying his sub-underwriting application shall not be presented for payment unless and until an allotment shall have been made to such sub-underwriter on his said application, and some application or allotment moneys on the shares so allotted remain unpaid at the expiration of 48 hours after notice of such allotment shall have been given to such sub-underwriter

It is now common practice that the Underwriters, as evidence of good faith, should, either in anticipation of the Agreement or on signing the Agreement, hand their cheque to the Company for the whole amount due on application for the shares underwritten On the other hand, it is only fair that the Underwriters should stipulate that this cheque be not presented until the risk underwritten has matured The Underwriting Agreement is a guarantee contract, it is not a firm application for shares The irrevocable nature of the Agreement and the power of attorney element in it

give the Company adequate safeguards Underwriters contend that it would be an unduly onerous condition if their cheques were cashed immediately and they were compelled to lie out of this substantial amount of money in the interval between the making of the Agreement and the actual allotment of shares, when the necessity of allotment to them might never arise

The practice is that, if subscriptions from the public fall short of the total offered, allotments are made to the Underwriters and approved sub-underwriters These gentlemen are informed of the amount due on application and allotment, and they are given, say, 48 hours' notice to pay If payment is not made, the Company then has the right to present the Underwriters' cheque which was handed over at the time of signing the Agreement in cover of the sums due on application for all the shares underwritten Under the provisions of Paragraph VI (see page 78), if any of the sub-underwriters fail to pay, the Underwriters must make good the default Paragraph IV may, therefore, be regarded as the general provision against default by the Main Underwriters themselves

NOW IT IS HEREBY AGREED as follows—

I For the consideration hereinafter stated and subject as hereinafter mentioned, the Underwriters hereby underwrite the subscription of of the said shares of the Company on the terms of the said Prospectus, and shall lodge with the Bank as the Company's Bankers, before the day on which the said Prospectus is first advertised, applications by themselves and by *sub-underwriters approved by the said Bankers*, for all the shares hereby underwritten, together, in the case of sub-underwriters' applications, with the sub-underwriters' cheques for payment of the deposit

of per share payable on application for the shares sub-underwritten by them The shares sub-underwritten and for which sub-underwriters' applications approved by the said Bankers are so deposited shall total at least shares

As the first main provision of the Agreement, this rightly gives the all-important information of the number of each class of shares underwritten The issuing house is usually the Main Underwriter In that case the number of shares underwritten should be at least the minimum subscription required by the Companies Act, 1929, and is preferably the whole issue offered to the public, less perhaps the known applications already made or agreed to be made by directors and other connections of the Company

The Underwriters do not sign an application for shares at the time of making the Agreement In the example given provision is made for approved sub-underwriters The general nature of the contract makes a separate application by the Underwriters for all the shares underwritten an unnecessary formality The Underwriters intend to pass on a substantial part of their obligation to approved sub-underwriters They bind themselves to lodge with the Company's bankers, before the day on which the Prospectus is first advertised, applications, accompanied by the relative cheques, from approved sub-underwriters up to a minimum amount, and their own application for the balance of the issue not sub-underwritten

Sub-underwriters' "approved" by whom?

In the paragraph quoted above, we have suggested that sub-underwriters should be approved by the Company's bankers This is not usual practice It is the only instance in the typical Underwriting Agreement where we have departed from current practice It is

a departure of importance, and we hope to justify it in the concluding chapter In current practice the expression used is "approved sub-underwriters," and the "approval" is done by the Company, that is to say, by its directors In the case of the new Company, where Main Underwriters and issuing house are usually one, approval of sub-underwriters by the Board has too often in the recent past been a mere formality

It is an essential part of the typical Agreement that applications, whether by Underwriters or by approved sub-underwriters, be lodged before the Prospectus is advertised It was, however, at one time quite common to have Agreements where applications were not to be made until the subscription list was closed The corresponding paragraphs in such Agreements ran somewhat as follows—

> "For the consideration hereinafter stated and subject as hereinafter mentioned, the Underwriters hereby underwrite the subscription of shares of the Company on the terms of the Company's Prospectus as finally settled and published and upon the form accompanying or referred to in such Prospectus
>
> If upon the publication of the Prospectus, the whole of the said shares shall be taken up by the public, then no allotment is to be made to the Underwriters, but if the whole shall not be so taken up, the Underwriters shall be called on to subscribe for and take up the residue"

An Agreement of this kind was a guarantee contract, but no cheque passed until allotment The well-known *Ormerod's case* (1894), 2 Ch 475, was fought on this issue The Underwriter did not apply, and when he was sued, pleaded that he only undertook to apply

if called on, and he was not called on to apply Under such circumstances, an allotment is not good if it is made before the Underwriter has been called on to apply for his proportion of shares

The element of uncertainty caused by this and subsequent decisions was overcome by grafting the power of attorney element on to such Underwriting Agreements by a paragraph in the following terms—

"As soon as conveniently may be after the time fixed by the Prospectus for the closing of the subscription list, and in any case not later than twenty-four hours thereafter, the Company is to inform the Underwriters of the number of shares for which the Underwriters are to subscribe in pursuance of Para hereof, and unless within twenty-four hours from such notice being given the Underwriters apply for the same the Company is to be at liberty to treat this Agreement as the application of the Underwriters for the same, and the Underwriters hereby undertake to pay the allotment money immediately after receiving notice of allotment The certificate of the Company in writing that the Underwriters have so failed and as to the number of shares they are bound to take shall be conclusive "

The practice, if it is met with at all nowadays, is probably confined to small issues by promoting syndicates It is not a satisfactory practice, and, with the standardization of the Underwriting Agreement, it is hoped that it will disappear completely

II If on or before the closing of the Subscription List as specified in the said Prospectus not less than the whole of the said shares shall have been *bona fide* applied for by the public, excluding applications withdrawn before allotment or rejected by the

directors of the Company as unsatisfactory, then no allotment, except in respect of firm applications, is to be made to the Underwriters or sub-underwriters in respect of their applications for shares

If the public subscribe in full and the Directors allot in full, the Underwriters are relieved of their obligations The Directors must have a certain amount of discretion as to whom they will allot If they have knowledge that certain applicants for shares are persons of little substance who will be unable to pay the calls when they fall due, it is their duty to reject the applications The stipulation that applications rejected by the Directors as unsatisfactory shall not go in relief of the Underwriters' obligations is a necessary one As to how far it is effective is another question A not uncommon method by which a certain class of unscrupulous Underwriters in the 1927–29 period evaded their obligations, if an issue was going badly, was to put forward persons of straw for large applications These Underwriters were usually small issuing houses of not much reputation Most issuing houses control a number of company registrations—the débris of past inquiries and investigations that did not get so far as a public issue A company was registered but no business was done The only shares allotted may have been the shares to the signatories of the Memorandum and Articles If an unscrupulous issuing house, working with a complaisant Board, wished to evade its underwriting contract, it put in applications for shares in the names of such companies When the Board allotted the shares, the Underwriters were relieved The cheques for the sums due on application might or might not be met If they were not met, the shares were forfeited If they were met, the Underwriters usually had a market deal in mind

It is easy to blame a Board for allotting such shares, but their difficulties should be borne in mind These practices, or malpractices, took place in the case of small issues by small issuing houses The issues were usually on behalf of new companies of poor quality formed to take advantage of the investors' craze of the moment One has only to recollect, for example, the nature of some of the gramophone issues of 1928 and 1929 The Directors of such companies had usually little or no financial experience, and certain of them, probably including the Chairman, were nominees of the issuing house and so of the Underwriters The issuing house could put up a very specious case to them for the necessity of allotting on such applications Public knowledge that the issue had failed would be a disaster On the other hand, a notice prominently displayed in the Press that the issue had been over-subscribed was essential if a market were to be made in the shares The vendor to the new company, who, under these circumstances, had probably been persuaded to put in a large application for shares to be satisfied out of his cash consideration, would add his plea to the arguments of the issuing house There might be a recalcitrant director with a reasonably keen sense of moral values He would resign The rest of the Board, after some heart searchings, perhaps, would proceed to allotment

No Underwriting Agreement, be it ever so carefully drawn, can prevent a practice of this kind It is outside the scope and power of the Agreement What the Underwriting Agreement can do, however, is to give the Board of the Company power to reject applications that they regard as unsatisfactory, and to refuse to consider any such applications as going in relief of the Underwriters' obligations

III If within such time as aforesaid less than the whole of the said shares are applied for by the public, excluding such applications as aforesaid, then the applications received shall go in relief *pro tanto* of the sub-underwriters and the Underwriters, who shall be allotted the residue only of the said shares not so applied for by the Public, and for this purpose the Underwriters are to rank as sub-underwriters in respect of any part of the said shares as shall not be sub-underwritten as aforesaid Notwithstanding such allotment, the Underwriters shall be responsible for and they hereby guarantee to the Company the due and punctual payment by all sub-underwriters to whom allotments are made of the application and allotment moneys payable on the shares allotted to them.

When the public do not apply in full, or when, after the Directors have used their discretion in rejecting unsatisfactory applications, the whole issue is not allotted to the public, the Underwriters must take up the residue While the Underwriters may pass on a large part of their obligation, they often retain a substantial portion for their own account For the purpose of defining the proportion in which shares shall be allotted, it is usual to provide that the Underwriters, for the underwriting they have retained, rank equally with the sub-underwriters in taking up the residue They are, however, in the paragraph given, responsible for the due and punctual payment by all sub-underwriters of the moneys due by the latter on application and allotment Sub-underwriters are recognized by the Agreement, but they are not parties to it The Main Underwriters are the guarantors of the issue, and the Company looks to them if any of the sub-underwriters defaults The Underwriters, of course, as we shall see, cover themselves by obtaining from

each sub-underwriter an Agreement that corresponds in many particulars to the Main Agreement, an application for the shares sub-underwritten, and a cheque in payment of the sum due on application for such shares

In the case, not so common to-day as it used to be, when there are a number of Main Underwriters, it is not unusual for a further provision to be inserted in this paragraph on the following lines—

> "All applications initialed by the Underwriters and approved by the Company, sent in by the Underwriters to the Company prior to the time fixed by the Prospectus for closing the list of subscribers, are to be applied in further relief of the Underwriters' obligation to subscribe hereunder, and shall not be considered subscriptions by the Public"

This position is, in principle, quite fair, and was contemplated even by the 1900 Act when it described underwriting commission as payment "to any person in consideration of his subscribing or agreeing to subscribe, whether absolutely or conditionally, for any shares in the company, or procuring or agreeing to procure subscriptions, whether absolute or conditional, for any shares in the company" When an Underwriter procures applications, it is not unreasonable that, as against other Underwriters, the allotments in respect of these applications should be set off against his underwriting obligations The practice, however, unless care is exercised, leads away from the guarantee principle, and there are loopholes for evasion in the "approved" clause Applicants procured in this way should be treated in precisely the same way as sub-underwriters

When there is only one Main Underwriter, as is the usual case when a company puts the issue in the hands of a well-known issuing house, the point does not arise

If the Main Underwriter were to use this provision, he might be held to be discriminating against his own sub-underwriters, and that is a view he would not like to be taken The practice, in fact, is a survival of early sub-underwriting methods, and it is hoped that it will now disappear

The corresponding provision possible to Main Underwriters is given in the type paragraph quoted above " and for this purpose the Underwriters are to rank as sub-underwriters in respect of any part of the said shares as shall not be sub-underwritten as aforesaid " This is sometimes carried a stage further in words such as these "As between the Underwriters and the sub-underwriters, the Company shall allot to the sub-underwriters in relief of the Underwriters the full amount of the said residue of shares applied for by the sub-underwriters" The clause in the type paragraph obviously inspires more confidence, and is considered preferable

V In consideration of and subject to the Underwriters duly carrying out the terms of this Contract, and paying or procuring to be paid all application and allotment moneys payable by the Underwriters or any sub-underwriters on any shares allotted to them, the Company will pay to the Underwriters in cash an underwriting commission of per cent and an overriding commission of per cent upon the issue price of the shares hereby underwritten by them, such commission to be paid within seven days after the allotment of the shares hereby underwritten Provided that, if an allotment is made to the Underwriters or any sub-underwriters, such commission is not to be payable until the application and allotment moneys payable in respect of the shares so allotted are paid, and so that such

commission may be applied by the Company in or towards payment of such moneys

The Underwriters' reward is their commission Now that the practice of sub-underwriting is recognized, the commission is usually expressed in two parts—as an underwriting commission and an overriding commission The overriding commission is the remuneration of the Main Underwriters for their responsibility and trouble in the matter, the underwriting commission is the payment that may be passed on wholly or in part to the sub-underwriters

The rate of the commission to be paid depends, naturally, on the prospects of success that it is judged the issue will have The knowledgeable investor always scrutinizes closely the short description of the underwriting contract, given usually, it is regretted to say, in very small type in an inconspicuous position at the end of the Prospectus The rate of the overriding and underwriting commissions and the standing of the Underwriters are at once an index of the nature of the issue and of its status

The time when the commission is payable is stated In the example given, it is payable within seven days after allotment, but if Underwriters or sub-underwriters have been called on to take up shares in terms of the Underwriting Agreement, it is not due until the application and allotment moneys on these shares have been paid The Company is given authority, if it chooses, to apply the commission in or towards payment of such application and allotment moneys

In addition to the cash commission, sometimes perhaps in lieu of it, there are in occasional issues, by way of further consideration, rights to receive preferential allotment of a different class of share or an option to take up shares at par within a certain time In the

case of *Hilder* v *Dexter* reported in Chapter V, Mr Hilder was given, for each share allotted, the option for a year to take up at par another ordinary share of £1, and if the option were exercised, he had a further option to take up still another ordinary share at par When a right of this kind is given in an Underwriting Agreement, the clause usually runs somewhat as follows—

"As further consideration, the Underwriters are to have the right, exercisable at any time before the day of , 19 , to call for the allotment at par of share(s) in the capital of the Company for every share(s) underwritten by them Every such call must be in writing under the hand of the Underwriters, served on the Company, and accompanied by the par value of the shares called for, and the Company is to allot the shares so called for to the Underwriters or to their nominees as the Underwriters may direct, and each call may comprise so many of the said shares as the Underwriters choose."

The underwriting of most mining ventures is in the hands of one or other of the great mining groups It is a usual provision in their Underwriting Agreements to have as part of the underwriting consideration a call on shares at par

VI The Underwriters hereby irrevocably authorize the Company and each of its Directors for the time being to put in, sign, and complete on their behalf, in the event of their failing themselves so to do, an application or applications in respect of the said shares hereby underwritten or any part thereof so as to make the same effective applications and to hand the same to the Company, and further hereby irrevocably authorize each of

such Directors on their behalf to conclude an agreement with the Company for an allotment to them pursuant to any such application And this Contract and such applications as aforesaid shall be irrevocable on the part of the Underwriters notwithstanding any purported withdrawal on their part or purported repudiation of their responsibility hereunder or under the said applications and shall empower the Directors of the Company to allot to them the number of shares, if any, which they become liable to have allotted to them hereunder and to enter their names in the Register of Shareholders, and the Underwriters undertake forthwith after notice of any such allotment to them to pay to the Company the sums payable on application and allotment for the shares so allotted

This paragraph was discussed at length in the preceding chapter The irrevocability and power of attorney constituted by it give the Underwriting Agreement its distinguishing characteristics The paragraph is repeated here in its due order in the Underwriting Agreement, so that its importance and meaning may be emphasized

VII This Agreement shall be void unless the said Prospectus is issued on or before the day of , 19 .

Time is the essence of an underwriting contract When the rate of commission is fixed, due regard is paid not only to the nature of the issue, but to the time at which it is being brought out The Company almost always wants the issue to be made as soon as possible The issuing house and the Underwriters are more concerned that it be over-subscribed by the public, so far as is possible in view of the Company's requirements,

they desire to choose the propitious moment But the considerations affecting finance change so bewilderingly in these days when they have become as international as national in their scope and effects, that a definite time limit must be placed on the issue of the Prospectus If the issue has not been made by that time, the Underwriting Agreement is void, and if it is desired to proceed, a new Agreement must be made

CHAPTER VIII

THE SUB-UNDERWRITING AGREEMENT

We have noted that there have been two main lines of development of the Underwriting Agreement On the one hand, the contract is now expressed as irrevocable and has acquired many of the elements of the power of attorney On the other hand, the practice has grown of Underwriters passing on part of their obligations to sub-underwriters In the example of a Main Agreement that we have analysed, the existence of sub-underwriters, although they were in no sense parties to the Agreement, was recognized

Growth of sub underwriting

When underwriting was in its infancy, vendors or promoters made underwriting agreements with a number of persons sufficient to ensure that the issue was guaranteed The procedure in *Carmichael's case*, reported in Chapter VI, was typical Mr Carmichael, as a principal, underwrote 1,000 shares out of an issue of 60,000 shares He certainly stipulated that if, on the publication of the Prospectus, he delivered applications for shares from responsible persons to the satisfaction of the vendor, these applications were to go primarily in relief of his underwriting obligation, but he remained the guarantor It was only a step further for an Underwriter to demand that if he persuaded other responsible people to guarantee part of the shares underwritten by him, the obligation under his guarantee should be reduced correspondingly Sect 8 of the 1900 Act, it will be remembered, made provision for this practice in the words—

> "It shall be lawful for a company to pay a commission to any person in consideration of

his subscribing or agreeing to subscribe, whether absolutely or conditionally, *or procuring or agreeing to procure subscriptions, whether absolute or conditional*"

After 1900 underwriting, now legally and fully recognized, became increasingly important Issues of capital grew larger every year, the issuing house as an intermediary between the company requiring capital and the public supplying it took form as a necessary part of money market machinery, and underwriting had to be organized On an occasional issue of £50,000 or £100,000 a vendor could canvass his friends to become guarantors, but with constant issues for larger amounts, these casual methods were impossible In practice, the issuing house became the Underwriters The Company about to make an issue naturally chose the issuing house that could guarantee subscriptions, and issuing houses had to make the organization of underwriting part of their business

The issuing house entered into the Main Underwriting Agreement with the Company, and distributed its risks among its following, much as an insurance company reinsures a proportion of a risk among its associates An issuing house is in touch with stockbrokers, banks, trust companies, finance houses, underwriting syndicates, and others who are on its books as willing to follow its lead and bear a share of the risk of issues that it sponsors These are the sub-underwriters

The contract between Main Underwriters and sub-underwriters takes the form of a Sub-underwriting Letter and Acceptance The type of Sub-underwriting Letter that might be issued in connection with the Underwriting Agreement given in the preceding chapter is as follows

No Cheques will be cashed unless Sub-underwriters are called upon to take up Shares

A B LIMITED

(Incorporated under the Companies Act, 1929)

SHARE CAPITAL

Divided into

Shares of each

ISSUE AT PAR OF

Shares of each

To C D & Co

Gentlemen,

(1) As I/we understand that you, for a commission to be paid you by the above-mentioned Company, are about to enter into a contract to underwrite the whole of the above Issue, I/we hereby agree to sub-underwrite Shares, and I/we hand you herewith an application for those Shares together with a cheque for £ , being per Share payable on application in respect thereof, and I/we agree to accept an allotment of any Shares that may be allotted to me/us in respect of such sub-underwriting, and to pay the amount due on allotment and all subsequent instalments due in respect thereof in accordance with and on the terms mentioned in the Prospectus as issued to the public

(2) I/we hereby irrevocably authorize you or any Director or official of your Company in my/our name(s) and on my/our behalf to sign and put in an application for the same or any smaller number of Shares, and to conclude on my/our behalf an Agreement with the Company to take the said Shares, or any part thereof, and to pay all moneys that may become due in respect of the same, which moneys I/we undertake to repay to you on demand, with interest thereon at the rate of per cent per annum from the date of payment to date of repayment

(3) It is understood that to the extent to which allotments are made to the public, I am/we are to be relieved of my/our underwriting obligations hereunder proportionately as nearly as may be with the

other sub-underwriters of the said Issue, except in respect of such number of Shares as I/we desire to take firm as indicated at the foot of this letter, and which are to be applied to the extent of the allotment in relief of my/our obligation to subscribe hereunder

(4) You are, as and when you are paid your underwriting commission by the Company, to pay me/us a commission of per cent per Share in cash on the Issue price of the Shares sub-underwritten by me/us

(5) If a Prospectus offering the said Shares for subscription has not been issued before the 19 , you are to return to me/us this Underwriting Letter and my/our cheque, and this Agreement will thereupon become void

(6) I/we hereby authorize you to agree with the Company the form of the Prospectus which is to be issued to the public offering the said Shares for subscription, and my/our obligations hereunder are to hold good notwithstanding any alteration that may be made in the draft Prospectus that has been shown to me/us, provided that the total amount of Shares offered for subscription and the price of Issue are not altered

(7) Any notice to me/us may be served by sending the same through the post to the subjoined address and shall be deemed to be served on the day when, in the ordinary course of post, the letter would reach such address

(8) I/we undertake not to offer for sale or sell, directly or indirectly, any of the Shares above mentioned until after the first general allotment to the public has taken place

dated this day of 19

Occupation or Description
(IN BLOCK LETTERS) Name (in full)
Address

Usual Signature

6d stamp

NUMBER OF SHARES DESIRED TO BE TAKEN "FIRM"

I/we wish to take * Shares of each "firm"

Signature

NOTE Firm applications by sub-underwriters will receive preferential consideration, but no undertaking must be implied that any such applications will be accepted for the whole or any part

ACCEPTANCE

We accept the above Sub-underwriting agreement

For and on behalf of

19

A B. LIMITED

(Incorporated under the Companies Act, 1929)

ISSUE AT PAR OF

Shares of each

FORM OF APPLICATION

To the Directors of

A B LIMITED

GENTLEMEN,

Having paid to your Bankers a deposit as follows—
per Share on Application for
of the above Shares £

I/we request you to allot to me/us such Shares upon the terms of the Company's Prospectus, dated , 19 , and the Memorandum and Articles of Association of the Company I/we hereby undertake and agree to accept the same or any less number of such Shares that may be allotted to me/us and to pay the further instalments due from me/us on any Shares allotted to me/us as provided by the said Prospectus, and I/we authorize you to place my/our name(s) on the Register of Members of the Company as the holder(s) of the Shares so allotted

Dated this day of 19

Usual Signature

Surname

(IN BLOCK LETTERS) (PLEASE STATE WHETHER MR MRS OR MISS)

PLEASE WRITE DISTINCTLY

Christian Name(s)

Address (in full)

Profession or Occupation

This form should be filled up and forwarded, with the amount payable on application, to BANK LIMITED, , or any of its Branches

Cheques must be made payable to "Bearer," crossed Bank Limited, "Not Negotiable," and marked " Limited" Any alteration from "Order" to "Bearer" must be signed by the Drawer

An acknowledgment will be forwarded in due course, either by Allotment Letter or return of the deposit

The sub-underwriting contract is constituted by the offer contained in the letter and the acceptance printed at the foot of the letter The Underwriters send two copies of the whole document to the sub-underwriter The latter completes them by filling in

the blanks with the number of shares he undertakes to sub-underwrite, signs the letter and the attached Application Form for the shares underwritten, and sends them back to the Main Underwriters with his cheque for the money due on application for the shares The Main Underwriters return one copy of the sub-underwriting letter with the acceptance signed by them, and the transaction is complete

Irrevocable and power of attorney

As will be seen from the second paragraph of the letter quoted above, the sub-underwriting letter has the same elements of a power of attorney and is as irrevocable as the Main Underwriting Agreement

The contract as constituted by the offer contained in the letter and by the signed acceptance is irrevocable The Underwriters are given authority, on behalf of the sub-underwriters, to complete and amend the application for shares or to substitute another application within the terms of the contract The cheque accompanying the sub-underwriting letter covers the sum due on application for the shares underwritten If the moneys due on application and allotment of the shares actually allotted in terms of the contract exceed the amount of this cheque, the Underwriters are authorized to pay the difference on behalf of the sub-underwriters and to charge the latter interest at the rate of per cent per annum from the date of such payment to the date of repayment by the sub-underwriters

The sub-underwriting letter an offer that must be accepted before the contract is complete

When a Main Underwriter applies for shares in the name and on behalf of a sub-underwriter, the authority so to do must be established The sub-underwriting letter is an offer Before the contract is complete, the offer must be accepted In the leading case of *Consort Deep Level Gold Mines, Ltd* (1897), 1 Ch 575, it was established that where a party, in exercise of

the authority apparently conferred by an underwriting letter, proposes to sign an application for shares, the Company has no right to presume the acceptance of the offer If the offer has not, in fact, been duly accepted, the application pursuant thereto is ineffective It is, therefore, important that the Underwriter should receive from each sub-underwriter an acknowledgment in writing of receipt of the notice of acceptance This is the best proof, if anyone challenges the right of the party to whom the letter is addressed to sign an application for shares in exercise of the authority apparently conferred by the letter The same rule applies if the Main Underwriting Agreement is by way of offer and acceptance The Main Agreement is usually on the lines of the example given in Chapter VI, although it may differ in certain particulars according to the practice of the Underwriters Of course, no acceptance is necessary with this form of contract, as both parties sign it In the early days of underwriting, before the practice of sub-underwriting had arisen, underwriting agreements often took the form of offer and acceptance The contract in *Carmichael's case*, given on page 82, is a good example This type of Main Agreement is rare to-day, but when it does occur, the Company has no difficulty in obtaining acknowledgment of the acceptance from the Underwriters The case is rather different with sub-underwriters In an issue of reasonable size there may easily be a large number of sub-underwriters The difficulty is surmounted by the device of printing the acceptance at the foot of the sub-underwriting letter and by each sub-underwriter forwarding the letter signed by him in duplicate to the Underwriter When the Underwriter returns the signed copy with his acceptance filled in, the effect is the same as an exchange of agreements

The Courts however frown upon those who sit quiet for a time and then come forward to say the contract was not complete In the well-known case of *Olympic Fire & General Insurance Company* (C A , 1920, 1 Ch 582, usually known as *Pole's case*) an irrevocable underwriting letter was treated as binding upon both Underwriter and sub-underwriter as soon as it reached the office of the Company It was also decided that a verbal application for shares made by the Underwriters is sufficient, and that an authority to the Underwriters to accept notice of allotment may be implied from the nature of the transactions between the Underwriter and the sub-underwriter without express authority The Court has held that, even without formal application, a Company which made allotments upon a list of names supplied to them by the Main Underwriters for the purpose had made proper allotments An underwriting or sub-underwriting letter may be accepted by conduct The mere retention of the sub-underwriting letter by the Underwriter, or by the promoter of the Company whose shares are underwritten, raises a presumption that the contract is complete These, however, are all by way of being exceptional cases To avoid argument, to make the contract clear cut and definite, it is invariable practice to-day to have the acceptance printed at the foot of the sub-underwriting letter, and to deal with it as we have described

A sub-underwriting letter is prima facie an offer, and the usual rules apply There is a moment of time in which the sub-underwriter may repent of his bargain, but it is a short moment The offer may be withdrawn at any time before acceptance, but it has been held that oral acceptance is sufficient The offer must be accepted within the time specified, or, if no time is specified, within a reasonable time Until the offer is

accepted and notice of acceptance given there is no contract But when by writing, by word, or by conduct, the Underwriters and the sub-underwriters have been informed that their offers are accepted, the contract is binding and the power of attorney which it contains comes into force The obligation constituted by the contract is absolute Death does not terminate the authority to apply for shares on behalf of the sub-underwriter

CHAPTER IX

THE SUB-UNDERWRITING AGREEMENT—ANALYSIS OF PROVISIONS

THE sub-underwriting letter has become much more standardized in form than the Main Agreement While the Main Agreement has tended to be wrapt in mystery, the sub-underwriting letter has been open to a large class of persons The clean wind of financial publicity has swept away ambiguities and anomalies The sub-underwriting letter to-day is a document precise, definite, and certain in its terms

When the Main Underwriters have decided on an issue, they circularize sub-underwriters somewhat in the following terms—

" Dear Sir,

A B Ltd

Capital £

Issue of—

Shares at par

We have pleasure in enclosing herewith draft prospectus, sub-underwriting letter and application form for the issue of the above shares We have reserved for you, subject to your immediate acceptance, a sub-underwriting participation of shares at an underwriting commission of per cent "

There follows a short description of the main features of the Company's business, stressing in particular the profits that have been and are being earned The factors that should make for over-subscription by

the public are indicated, and the circular usually ends—

> "If you desire to avail yourself of the reservation of sub-underwriting that we have made on your behalf, we shall be glad if you will complete the enclosed sub-underwriting letter and return it to us with your cheque representing the deposit of per share not later than "

Now let us look at the provisions of the sub-underwriting letter We shall keep to the example given in the preceding chapter

No Cheques will be cashed unless Sub-underwriters are called upon to take up Shares

This sentence is invariably printed in heavy type at the top of the letter The sub-underwriting agreement is a guarantee contract Adequate provision is made in the body of the letter for the payment of the sums due on application and allotment of any shares that may be allotted, in terms of the agreement, to sub-underwriters At the time of the 1928 and 1929 underwriting scandals, it was often urged that sub-underwriting cheques should be cashed Other methods are open to make Underwriting Agreements effective If the practice of presenting sub-underwriting cheques for payment became general, the circle of sub-underwriters would substantially contract, and good underwriting would become more difficult than ever to secure Moreover, if the public respond to the invitation to subscribe, the return of the amounts paid by the sub-underwriters would in many cases cast a very onerous burden on the clerical staff whose energies should be concentrated on dealing with the public applications When a man guarantees a friend's

account at a bank, the bank does not require him to deposit cash or securities for the amount of the guarantee To insist on cashing sub-underwriting cheques would be to depart from the spirit of the underwriting contract as a guarantee contract

(1) As I/we understand that you, for a commission to be paid you by the above-mentioned Company, are about to enter into a contract to underwrite the whole of the above Issue, I/we hereby agree to sub-underwrite Shares, and I/we hand you herewith an application for those shares together with a cheque for £ , being per Share payable on application in respect thereof, and I/we agree to accept an allotment of any shares that may be allotted to me/us in respect of such sub-underwriting, and to pay the amount due on allotment and all subsequent instalments due in respect thereof in accordance with and on the terms mentioned in the Prospectus as issued to the public

The Main Underwriters very often, one might almost say as a rule, make sure of the sub-underwriting before they sign the Main Agreement It will be recollected that in Paragraph I of the type Main Agreement given on page 76, the Main Underwriters bind themselves to produce to the Company a stipulated minimum of approved sub-underwriting contracts There are several reasons for this procedure As has been made clear, underwriting in this country is not in the hands of the banks The good issuing houses are substantial institutions, but even their resources might be strained unduly if they had to take up a large part of an issue in terms of their Agreement There is also another consideration If an issue does not go well with the public, the market in the shares assumes an importance from the Company's point of view that it does not

have in the case of a successful issue It is very comforting to the Board, if an issue fails with the public, to know that the residue of the shares is well spread among strong sub-underwriters

Other opening paragraphs of the sub-underwriting letter in common use are as follows—

"I/We, the undersigned, for the consideration below stated, hereby sub-underwrite of the above shares of each on the terms of the Prospectus, as finally settled and filed with the Registrar of Companies, to be issued by the Company offering the said shares for subscription to the Public, a proof of which Prospectus marked "Incomplete draft, subject to revision" has been shown to me/us, and I/we hand you herewith an application for such shares, together with a cheque for per share payable on application for such shares"

Or—

"Referring to the underwriting or proposed underwriting by you of shares of each in the above-named Company, I/we, the undersigned, for the consideration and on the conditions below stated, hereby sub-underwrite to you of the above shares underwritten or to be underwritten by you on the terms as to payment and otherwise of the Prospectus to be issued by the Company offering the said shares for subscription to the public, a proof of which Prospectus marked "U" has been shown to me/us I/we hand you herewith cheque in your favour for £ , being the amount payable on application of per share hereby sub-underwritten by me/us, together with application form duly signed by me/us and addressed to the Company"

(2) I/we hereby irrevocably authorize you or any Director or official of your Company in my/our name(s) and on my/our behalf to sign and put in an application for the same or any smaller number of Shares, and to conclude on my/our behalf an Agreement with the Company to take the said Shares, or any part thereof, and to pay all moneys that may become due in respect of the same, which moneys I/we undertake to repay to you on demand, with interest thereon at the rate of per cent per annum from the date of payment to date of repayment

We have dealt with this paragraph in the preceding chapter, but it may be interesting to give a variant that is in common use—

"This Agreement and Sub-underwriting Application are to be irrevocable provided the issue is made on or before the day of 19 , and are to be sufficient in themselves to authorize you to procure the allotment of Shares to me/us thereon, and I/we hereby authorize you to insert the date of the said Prospectus in the said application, and if I/we affect to repudiate or withdraw such application, or fail to hand the same to you herewith, you or any of your officers are hereby irrevocably authorized to sign and put in in my/our name(s) and on my/our behalf an application in similar form for the same or any less number or amount of Shares and to pay the application money payable thereon, and to procure the allotment to me/us pursuant thereto, and I/we will pay the application and allotment moneys accordingly on receiving notice of allotment"

(3) It is understood that to the extent to which allotments are made to the public, I am/we are to be relieved

of my/our underwriting obligations hereunder proportionately as nearly as may be with the other sub-underwriters of the said Issue, except in respect of such number of Shares as I/we desire to take firm as indicated at the foot of this letter, and which are to be applied to the extent of the allotment in relief of my/our obligation to subscribe hereunder

Emphasis is placed on allotments to the public, not on applications by the public Subscriptions by the public withdrawn before allotment or rejected by the directors as unsatisfactory, are dealt with in the Main Agreement While corresponding clauses are not infrequently inserted in the sub-underwriting letters, it has become more usual to omit them, and to refer to allotment only

In the Main Agreement, it will be recollected that the Main Underwriters were to rank equally with sub-underwriters for any portion of the issue retained by them Although this practice is well understood, it is sometimes mentioned specifically in the sub-underwriting letter as follows—

> "To the extent to which allotments are made to the public, I am/we are to be relieved of my/our obligations hereunder proportionately as nearly as may be with the other sub-underwriters of the said issue, for which purpose you are to be treated as sub-underwriters for any part of the said shares which has not been sub-underwritten by other parties"

Firm applications

It is right that firm applications should not be treated as applications by the public, but that allotments made thereon should be applied exclusively in relief of the sub-underwriters by whom they were put in So far as firm applications are concerned, the Agreement is

more than a guarantee contract The Underwriters want these shares as a permanent investment The Trust Companies and Insurance Companies, for instance, usually apply "firm" for a portion of the shares they sub-underwrite The theory behind this practice is sound The Directors of Trust Companies and the Investment Managers of Insurance Companies are custodians of other people's money for the purposes of investment No matter how favourable they think the omens for an issue may be, they feel that they should not sub-underwrite unless they are prepared to take a line of the shares as a permanent or quasi-permanent holding If the issue is of a nature that they do not think would be suitable for their portfolios, they usually leave its sub-underwriting alone Sub-underwriting in such a case would entail a risk that an individual might willingly accept, but it is alien to the principles that govern the administration of large investment funds

On the other hand, if the issue is one that these Companies would willingly have on their books, firm sub-underwriting is an excellent opportunity of obtaining the shares on favourable terms If the issue goes well and the public over-subscribe, the sub-underwriter receives a preferential allotment for the part of his sub-underwriting application that is "firm" Suppose, for instance, that he has sub-underwritten 5,000 shares of £1 each at a commission of 3 per cent, and agreed to take firm 1,000 of these shares The commission amounts to £150, and the 1,000 shares allotted to him can stand in his books at £1,000 less £150, or £850, that is to say, at 17s a share Over-subscription is usually the precursor of a good market in the shares Disappointed applicants satisfy their requirements by purchases through the Stock Exchange, and the many people who saw the Prospectus, liked the issue, but

hesitated to apply, are now emboldened to add the shares to the list of their holdings The shares therefore may rise to quite a substantial premium, and the Trust Company Director or Insurance Investment Manager feels that by his sub-underwriting operation he has done his duty by his shareholders

If the issue goes badly, the sub-underwriters are allotted their proportion of the residue, but allotments made in respect of the firm applications are applied towards satisfaction of the quota they must take up in terms of the sub-underwriting agreement Let us suppose, in the example given above where the sub-underwriter guaranteed 5,000 shares of £1 each at a commission of 3 per cent, that the public applied for and were allotted 60 per cent of the issue, leaving 40 per cent to be divided among the Underwriters The proportion applicable to our sub-underwriter would be 40 per cent of 5,000 shares, or 2,000 shares, but his firm application would account for 1,000 of these shares, leaving a further 1,000 to be taken up The cost to him of these 2,000 shares is £2,000 less £150 (the commission of 3 per cent on 5,000 shares), or £1,850 net, equivalent to 18s 6d per share When dealings began in the shares, they would probably open at a small discount Our Underwriter would not be unduly worried He had applied firm for the shares on their merits He certainly had had to take up a larger number than he expected, but he would know that the market in the shares was in safe hands He had 1s 6d a share in reserve, and could afford to wait until the market improved before disposing of the shares that were surplus to his permanent requirements

Sometimes the Main Underwriters cannot guarantee that firm applications will be allotted in full if the issue is successful It is customary in such cases to insert

a note in the Letter that they are unable to offer any firm underwriting, but that, if any sub-underwriter desires to secure allotment and will notify the number of shares he desires to obtain, they will endeavour to procure the allotment of these shares Underwriters and issuing houses must play fair with their sub-underwriters, they depend on them so much The sub-underwriter knows therefore that, even with a reservation of the kind mentioned, he will obtain his firm allotment unless circumstances are exceptional

Purists have objected to firm underwriting on the ground that it is, or can be, a method of evading the Companies Acts and obtaining shares at a discount They point out that it is an absolute agreement to subscribe in any case, whether or not the public applies for the shares In other words, it is nothing more than a subscription in advance It is true that, prior to the 1929 Act, firm underwriting was on occasion used as a method of issuing shares at a discount, but now that the rate of underwriting commission is restricted to a maximum of 10 per cent of the nominal value of the share or stock, and shares may be otherwise legally issued at a discount under conditions, the distinction between a commission and a discount should be more clear

There still survives in current sub-underwriting practice the provision to which we referred in Chapter VII, to the effect that applications procured by the sub-underwriters and approved by the Company shall not be considered applications by the public but are to be applied in special relief of the sub-underwriters' obligation The usual clause runs—

> "All applications initialed by me/us and approved by you sent in by me/us prior to the time fixed by the Prospectus for closing the list of subscribers are

to be applied in special relief of my/our obligation to subscribe hereunder, and shall not be considered subscriptions by the public"

This is no better practice in a sub-underwriting letter than in a Main Agreement, and it is hoped that in time it will disappear

(4) **You are, as and when you are paid your underwriting commission by the Company, to pay me/us a commission of per cent per Share in cash on the Issue price of the Shares sub-underwritten by me/us**

It will be remembered that in the Main Agreement given in Chapter VI, the underwriting commission was not payable by the Company to the Main Underwriters until all moneys due by sub-underwriters on application and allotment had been paid The sub-underwriting letter we are considering has been drafted in relation to that Main Agreement There is, therefore, no necessity to embody in it any provision to the effect that the commission is not to be payable until the moneys due on application and allotment have been paid by the sub-underwriters The Main Underwriters will not get their commission until the sub-underwriters have fulfilled their obligations If the Main Underwriters have to pay on behalf of any sub-underwriters the sums due on application and allotment, they have their remedy under Paragraph (2) The sub-underwriters must repay these sums on demand, and a substantial rate of interest as a rule is stipulated in the case of any delay

It is quite usual to make the position clear by a paragraph on the following lines, which may be considered alternative to the one given—

"In consideration of this Agreement you are to pay me/us an underwriting commission of per

cent in cash on the nominal amount of the shares hereby sub-underwritten, such commission to be paid within fourteen days after allotment If any of the said shares are allotted to me/us, no commission is to be payable until the moneys due on allotment under the terms of the said Prospectus have been paid by me/us and you may apply the commission in or towards the payment of such moneys "

The type paragraph given is usually associated with a strong Main Agreement The variant is too often used with weak Main Agreements where, as we shall see in Chapter X, the Main Underwriters have passed on their guarantee obligations wholly to the sub-underwriters

(5) If a Prospectus offering the said Shares for subscription has not been issued before the 19 , you are to return to me/us this Underwriting Letter and my/our cheque, and this Agreement will thereupon become void

The date of the issue must not be unduly delayed Time is of the essence of an underwriting contract The sub-underwriter has accepted the risk largely because he believes the time to be favourable for the issue If the date of issue is delayed, new factors may emerge that alter completely the prospects of the issue's success It is, therefore, stipulated that, if the Prospectus has not been issued before a certain date, the sub-underwriting agreement becomes void A variant of the paragraph in the following terms is sometimes met with—

"This Agreement and the said application are to be irrevocable except that, if the Prospectus offering

the said Shares for subscription is not filed with the Registrar of Joint Stock Companies on or before the , 19 , either party may, by seven days' notice in writing to the other, revoke the same"

This is not considered to be good practice It takes away from the definiteness and precision of the sub-underwriting letter Provisions that introduce any element of doubt or uncertainty into underwriting contracts should be avoided

(6) I/we hereby authorize you to agree with the Company the form of the Prospectus which is to be issued to the public offering the said Shares for subscription, and my/our obligations hereunder are to hold good notwithstanding any alteration that may be made in the draft Prospectus that has been shown to me/us, provided that the total amount of Shares offered for subscription and the price of Issue are not altered

In current practice the sub-underwriters rely on the Main Underwriters to see that the Prospectus finally issued is substantially the same as the underwriting draft shown to them when they signed the sub-underwriting letter Last-minute alterations in the Prospectus are generally found to be necessary in almost every issue It is obviously desirable to leave scope for alterations, and, where the Main Agreement stipulates that all changes must have the consent of the Main Underwriters, the sub-underwriters can safely leave the protection of their interests in the hands of the Main Underwriters If there were no authority to alter, it would be necessary to secure the consent of every sub-underwriter to each change in the Prospectus

(7) Any notice to me/us may be served by sending the same through the post to the subjoined address and shall

be deemed to be served on the day when, in the ordinary course of post, the letter would reach such address

This paragraph is designed to add precision to the contract Many legal cases have been fought by sub-underwriters on the ground that they have not received proper notice or advice of matters appertaining to or arising out of the Agreement Nowadays the Main Underwriters keep a record of posting all and every communication addressed to the sub-underwriters, and under the paragraph given above, this constitutes proof of service

(8) I/we undertake not to offer for sale or sell, directly or indirectly, any of the Shares above mentioned until after the first general allotment to the public has taken place

The whole tenor of the sub-underwriting letter which we have been considering is that sub-underwriters should keep to their job The process of passing on obligations has gone far enough when the Main Underwriters have had a considerable portion of the issue sub-underwritten Even in respect of the portion sub-underwritten they remain as guarantors, and the purpose of the whole contract, including both Main Agreement and sub-underwriting letters, is fulfilled It is another matter when sub-underwriters are allowed to put in applications by their friends, and, when these applications have been approved either by the Company or by the Main Underwriters, as in the variant given on page 124 under Paragraph (3), to claim that they be applied in relief of their sub-underwriting obligation With a provision of this nature an unscrupulous sub-underwriter has at his hand a loophole for escape The type sub-underwriting letter that we give does

not countenance the practice It goes further It prohibits the sub-underwriter from offering for sale, directly or indirectly—and "indirectly" is a very wide term—any of the shares he has sub-underwritten until after the first general allotment to the public has taken place

It is submitted that the type sub-underwriting letter discussed in this chapter is definite, precise and certain, and that, taken in conjunction with the Main Agreement given in Chapter VI, it maintains the guarantee nature of the whole underwriting contract

CHAPTER X

THE DETERIORATION OF THE MAIN UNDERWRITING AGREEMENT BETWEEN 1920 AND 1929

The unique position of the sub underwriter in England

We have seen how the growth of underwriting, in view of the state of the capital market in this country, produced as a logical consequence the practice of sub-underwriting The development of the Underwriting Agreement has had two main strands on the one hand, irrevocability, power of attorney, certainty, on the other hand, the spreading of part of the risk among sub-underwriters In other countries, where issues are in the hands of the banks, the sub-underwriter as we know him does not exist In England, where issuing houses are specialist organizations, often of great experience and repute, but seldom of large capital resources, the spreading of risks among sub-underwriters has been necessary and, indeed, inevitable In fact, in the best type of Main Agreement, the Company stipulates as part of the contract that a minimum amount of approved sub-underwriting be obtained by the Main Underwriters

A development not foreseen or regulated by the Companies Acts

When the Companies Act, 1900, recognized underwriting, this position was not contemplated Our legislators had in view only the situation where Underwriters contract directly with the Company Although the spreading of risks among sub-underwriters has become an essential part of underwriting practice, the Legislature has not modified its attitude The Companies Act, 1929, regulates strictly the conditions governing the payment of underwriting commission It enacts that the rate of commission must be disclosed

in the Prospectus and shown in the Company's balance sheet The only reference to sub-underwriters is that made in the Fourth Schedule to the Act, quoted on page 67, where it is specifically mentioned that commissions to sub-underwriters need *not* be disclosed in the Prospectus Particulars of the Main Underwriting Agreement must be shown in the Prospectus, but, as the Company is not a party to the sub-underwriting agreements, mention of the latter is not required

In practice, as we have observed, the issuing houses, after 1900, took upon themselves the organization of underwriting They were the Main Underwriters They passed on a substantial part of their obligation to sub-underwriters, but they remained guarantors of the issue Disputes at times arose, and were on occasion taken to Court, as to how far Main Underwriters were responsible for defaults by sub-underwriters in cases where a company had approved the applications for shares by sub-underwriters, but up to 1920, the system worked fairly well There were never sufficient issuing houses of repute for industrial issues The capital market was inadequately organized, but, such as it was, it functioned with reasonable efficiency When the War came to an end, several new issuing houses were formed amid a flourish of trumpets The necessity for them was widely recognized We had just emerged from the greatest war in history, and it was obvious that a vast amount of industrial reconstruction must be done We hoped that at last England was going to develop her capital market along her own lines England had led the world in almost every other type of financial organization Other countries had perhaps devised better methods of providing industry and trade with their permanent capital, but now that England had roused herself to the urgency of the problem, she could be

safely left to work out her own salvation These high hopes were only imperfectly fulfilled The troubles of 1928 and 1929 were a sorry commentary on the post-war effort

The capital needs of industry and trade were clamant There were not sufficient issuing houses of standing to satisfy the demand, or, alternatively, the resources and organization at the command of these issuing houses were not adequate to cope with the requirements of the capital market The profits earned by a well-run issuing house in a time of industrial activity are substantial, the profits within the grasp of an unscrupulous issuing house can be very substantial There sprang up a large number of second-rate institutions, with scanty connections and resources, eager to snatch a profit while the public were in an investing mood In the 1927–29 period, the capital market presented an extraordinary spectacle There were a number of first-class issuing houses who fulfilled their engagements scrupulously After them came a host of organizations, some large, others small, some that lived a few years, others that were simply promotion syndicates for a single issue If issues went well, these bodies reaped handsome profits If issues went badly, they defaulted in their engagements and probably were wound up

The existence of these unsatisfactory organizations was made possible by the deterioration of the Main Underwriting Agreement that set in soon after 1920 When an issuing house guarantees an issue, it must exercise reasonable care If the issue fails, the resources of the issuing house will be strained unless the sub-underwriters among whom it has spread a large proportion of the risk are able to meet their engagements On the other hand, if the issuing house can enter into a

Main Underwriting Agreement and yet slip out of the guarantee obligation, it is obvious that it has become merely a piece of machinery without responsibility Only the Main Agreement need be disclosed in the Prospectus The public are given the impression that the issuing house as Main Underwriter has guaranteed the issue If, in fact, the issuing house has contracted out the whole of its guarantee obligation to sub-underwriters, one of its main functions disappears In too many instances, the temptation then has been to see how much easy money could be made out of issues In times of market activity, an unscrupulous issuing house that has rid itself of the guarantee obligation need not care very much whether an issue succeeds or not If a few of the issues fail, it may suffer in reputation, but that does not worry it unduly There are many more companies requiring capital, and there are ways and means of protecting sub-underwriters Dummy companies can be used to put in large applications for shares when the subscription list opens, the vendor can be made to see "reason," market deals in the shares can be arranged with outside brokers It may be objected that these conditions existed only on the dubious fringe of the capital market The extract from the Macmillan Report quoted at the end of Chapter II has shown that the facts are otherwise British investors lost tens of millions of pounds between 1927 and 1930 as a direct result of these practices In the Press and judicial comment of the time, the importance of the deterioration of the Main Underwriting Agreement, as perhaps the most powerful single cause of this state of affairs, was largely missed The reason for this, of course, was the secrecy that has always enshrouded the Main Underwriting Agreement

Let us see precisely how the deterioration came

about Generally speaking, up to 1920 the Main Underwriters were principals and guaranteed the issue We give below a good type of 1920 Main Underwriting Agreement It will be observed that this Agreement is substantially on the lines of that discussed in Chapters VI and VII With certain modifications to bring it into line with current practice, it is the form still used by certain powerful issuing houses

A 1920 Main Underwriting Agreement

AN AGREEMENT made the BETWEEN A B Ltd whose registered office is situate at (hereinafter called the Company) of the one part and C D & Co of (hereinafter called the Guarantors) of the other part WHEREAS the Company has been registered under the Companies Acts 1908 to 1917 with a capital of divided into Ordinary Shares of each AND WHEREAS the Company is about to offer for subscription in the United Kingdom at par Ordinary Shares of each AND WHEREAS a draft of a Prospectus making such offer has been prepared and is annexed hereto but it is contemplated that such draft Prospectus may be altered in some respects before it is finally settled and filed in pursuance of the provisions of the Companies (Consolidation) Act 1908 AND WHEREAS the Guarantors are willing and have offered to underwrite the subscription of shares at par upon the terms and subject to the conditions hereinafter contained NOW IT IS HEREBY AGREED AS FOLLOWS—

1 The Guarantors will before 12 o'clock on the first day fixed by the Prospectus offering such shares for subscription for the opening of the subscription list hand to the Company applications (which shall be irrevocable) by the Guarantors and/or by other responsible persons or Companies to the reasonable satisfaction of the Company signed by the Guarantors and/or by such other responsible persons or Companies at par for the shares the

subscription of which is to be guaranteed by them as aforesaid together with a cheque or cheques for the deposit of per share payable in respect of such shares

2 The Guarantors hereby irrevocably authorize the Company to complete any such application forms which may be undated or on which the date of the Prospectus or any other matter may have been left blank by dating the same and by filling in the date of the said Prospectus and/or by filling up any other blanks in such forms

A guarantee contract

3 In the event of the Guarantors failing to hand in applications which they are as aforesaid liable to hand in together with the deposit of per share, it shall be lawful for the Company in the name and on behalf of the Guarantors to apply for the said shares and to pay the Company the amount payable in respect of such applications and this authorizing shall be irrevocable The Guarantors shall keep the Company and its nominees indemnified against all liability in respect of such applications

4 The said Prospectus shall be in the form of the proof annexed and signed for identity by the Guarantors with such alterations as may be mutually agreed by the parties hereto

5 If on or before the closing of the subscription list the said shares offered for subscription by the said Prospectus are bona fide applied for by the public (after excluding applications handed in by the Guarantors in pursuance of Clause 1 hereof and/or subscriptions withdrawn before allotment and/or subscriptions rejected by the Directors as unsatisfactory) accompanied by the amount payable in respect thereof on application then no allotment is to be made in respect of the said applications handed in by the Guarantors and the said cheque or cheques or the proceeds thereof shall be returned to the Guarantors and/or the other applicants

6 Any number of the said shares which may not be so bona fide applied for and allotted to the public shall be allotted *pro rata* to the underwriters thereof

in proportion to the numbers of shares severally subscribed by them respectively whether the applications are specially endorsed or otherwise directed to be treated as firm applications or not but so nevertheless that as amongst such underwriters all firm applications shall have priority of allotment over other applications and that any number allotted in respect of any firm applications shall be taken to that extent in satisfaction of the applicants' *pro rata* proportion of the number of shares allotted to the Guarantors and/or such other responsible persons or Companies as aforesaid

7 In consideration of the undertakings on the part of the Guarantors hereinbefore contained the Company shall pay to the Guarantors a commission at the rate of per cent in respect of the said shares the subscription of which is guaranteed by them, such commission to be paid within 14 days after allotment of the said shares offered for subscription provided that all sums payable on application and allotment in respect of the said shares shall have been previously paid to the Company

8 This Contract is to be null and void unless the Prospectus of the Company be issued on or before the day of 1920

A B & Co Ltd
6d
C D & Co

The guarantee nature of the contract is fully recognized The Main Underwriters, in fact, describe themselves, not as Underwriters but as Guarantors Attention is directed especially to Paragraph 7—

"In consideration of the undertakings on the part of the Guarantors hereinbefore contained the Company shall pay to the Guarantors a commission at the rate of per cent in respect of the said shares the subscription of which is guaranteed by them,

such commission to be paid within 14 days after allotment of the said shares offered for subscription *provided that all sums payable on application and allotment in respect of the said shares shall have been previously paid to the Company*"

The commission had to be paid within a fortnight of allotment If there were defaults, the guarantors were called on to make them good This position was recognized by making it clear in the commission paragraph that commission was not payable until the moneys due on application and allotment on *all* the shares underwritten had been paid to the company Every professional accountant who is brought into contact with share issues has been faced with the problem of determining whether and to what extent cheques received as application and allotment deposits in good faith by the Directors are cash in the hands of the Company The provision of a 14-day interval after allotment removed the possibility of difficulties of that kind arising Ample time was given for the cheques to be paid into the bank and cleared The Underwriters only got their commission when the Company was in possession of its capital

Stages in the deterioration of the guarantee provision

From 1920 onwards there was, as previously stated, a gradual deterioration in the Main Underwriting Agreement The first stage in the deterioration made its appearance about 1920, and it affected this very point of the time of payment of the Underwriter's commission The practice crept in of omitting the words in italics in the paragraph quoted above The paragraph then read—

"In consideration of the undertakings on the part of the Guarantors (or Underwriters) hereinbefore contained the Company shall pay to the Guarantors

(or Underwriters) a commission at the rate of per cent in respect of the said shares the subscription of which is guaranteed (or underwritten) by them, such commission to be paid within 14 days after allotment of the said shares offered for subscription"

Underwriters began to insist that the commission should be paid within 14 days after allotment, whether or not the Company had received the moneys due on application and allotment In this way, if the Company approved the sub-underwriters by accepting their cheques and allotting shares to them, but some of the sub-underwriters defaulted on their cheques or otherwise failed to meet their obligations, the full commission was, nevertheless, payable to the Main Underwriters

Facilis descensus Averni In a very few years, the trend was carried much further until it was established as quite common practice that the responsibility of the Underwriters ceased when a company approved the sub-underwriters A typical paragraph in 1928 Main Underwriting Agreements ran as follows—

"The Underwriters will, upon the opening of the list of applications, hand to the company or its bankers applications by sub-underwriters at par for the shares together with a cheque or cheques for the deposit of per share payable in respect of such shares *Such sub-underwriters' applications shall be to the satisfaction of the Directors of the company or their representatives and when the Directors of the company shall have considered and approved such sub-underwriting to the full amount of shares* THE UNDERWRITERS SHALL BE RELIEVED OF THEIR GUARANTEE IN RESPECT THEREOF"

The Main Underwriting Agreement—the Agreement that must be disclosed in the Prospectus and that is

regarded by the investor as the safeguard of the issue —had ceased to be a guarantee contract It had become a mere agreement to procure sub-underwriting

The Main Underwriters had succeeded in passing on the whole of their obligations to the sub-underwriters, and the door was wide open for the abuses of the practice that followed immediately These abuses were almost wholly in connection with new companies In 1928, seldom a day passed in which the Press did not report strong comments by the Court or by the Official Receiver on the collapse of companies caused directly through the failure of sub-underwriters to meet their obligations

The North British Artificial Silk case

To appreciate the full significance of the practice of Underwriters contracting out their obligations, the published reports of the case of *North British Artificial Silk, Ltd* v *Tokenhouse Securities Corporation, Ltd*, should be considered In this case, Tokenhouse Securities Corporation, Ltd , the issuing house, underwrote 345,000 shares of £1 each, and the Main Underwriting Agreement contained a paragraph, on the lines of that quoted above, to the effect that Tokenhouse Securities Corporation, Ltd , should be released from liability if the Directors of North British Artificial Silk, Ltd , approved of the sub-underwriting for the full amount Tokenhouse Securities Corporation, Ltd , besides being issuing house and Main Underwriter, was appointed Registrar for the issue, and put forward lists of sub-underwriters to whom the Directors should allot The Directors then resolved to allot to these persons without giving the names much consideration The result was that a large proportion of the sub-underwriting turned out to be useless, but as the Directors had obviously approved the sub-underwriters by allotting to them, Tokenhouse Securities Corporation, Ltd , was relieved

of all responsibility The following Report is reproduced from *The Times* of 23rd November, 1929—

COURT OF APPEAL

Appeal in Underwriting Agreement Dispute Dismissed

North British Artificial Silk, Limited v *Tokenhouse Securities Corporation, Limited*

(Before Lord Justice Scrutton, Lord Justice Greer, and Lord Justice Slesser)

The Court dismissed this appeal by the plaintiffs from the judgment of Mr Justice Rowlatt The action was brought by North British Artificial Silk, Limited, claiming to recover from Tokenhouse Securities Corporation, Limited, under the terms of an underwriting agreement, £19,425 in respect of deposits of 2s 6d a share on 155,400 Preferred Ordinary shares in the plaintiff company

The plaintiff company was registered on February 25th, 1928, with a capital of 345,000 10 per cent Preferred Ordinary shares of £1 each and 800,000 Deferred Ordinary shares of 1s each The defendant corporation was the issuing house and the agreement sued on was one whereby the defendants undertook to procure sub-underwriting contracts

A number of sub-underwriting contracts were, in fact, procured by the defendant corporation, but the plaintiffs alleged that they proved to be worthless and that the cheques paid by way of deposit on the shares underwritten by defaulting sub-underwriters were dishonoured Eventually, they said, 155,400 shares of £1 each were left on the hands of the plaintiff company and had to be reissued by the company at a heavy loss

The defendants denied those allegations and contended that, once the plaintiffs accepted the applications and made the allotments, the defendants were relieved of their liability under the underwriting agreement

Mr Justice Rowlatt held that the plaintiffs had not made out their case and gave judgment for the defendants with costs

JUDGMENT

Lord Justice Scrutton, in giving judgment, said that he regretted to say that the appeal must be dismissed, and he regretted to say it because the case seemed to be a very bad example of the sort of thing that had been going on in the City of London during the last three or four years in connection with underwriting

Where there had been a new company to be formed during the "boom" which had come to an end it had been a case of "where the carcass is, there the birds of prey will be gathered together," and either as promoters, or as Underwriters or sub-underwriters, they had been making as much as they could from a new company at a time when it had very insufficient protection from its directors

When the appellant company was promoted it was expected that the public, following the course of speculative gambling, would rush in and take the shares The shares were underwritten by the respondents, and the question to be decided turned on the construction of the agreement between the appellants and the respondents with regard to the underwriting The respondents were to receive 5 per cent commission for the underwriting, and the sub-underwriters were to receive 4 per cent out of that, leaving 1 per cent for the respondents and that at a time when the public were rushing in to subscribe in any company, however ridiculous, with consequences which had been seen in the winding-up of those companies At that time Underwriters and sub-underwriters were getting a good deal of money subscribed by the public for no particular services

Of the sub-underwriting contracts in the present case for 345,000 shares of £1 each those relating to 155,000 were ridiculous, and if any inquiry had been made by the respondents, they would have found that they were ridiculous One, for 55,000 shares, involving a liability of £55,000, was from a man who had a county court judgment against him for £15

Tokenhouse Securities recognized that it was a ridiculous performance of their contract to put forward applications such as those by declining to claim the commission

of 1 per cent for themselves and 4 per cent for the sub-underwriters in respect of the 155,400 shares

In view of the agreement with Tokenhouse Securities, the shareholders of the appellant company had grave reason to complain of the directors who considered those underwriting applications Without any proper consideration the two directors to whom the task was delegated took the most effective steps of approving the sub-underwriters—they allotted the shares He could conceive of directors saying that they would not proceed on sub-underwriting contracts until they knew more about the sub-underwriters He could conceive of them directing the cheques for moneys payable on application to be presented for payment so soon as they were handed into the bank If that had been done the fat would have been in the fire at once, for the man with a county court judgment against him was not likely to be able to meet his cheque for an eighth of £55,000

But neither of those courses was taken The directors having considered and approved the sub-underwriting applications, the Tokenhouse Securities Corporation were relieved of their obligations under the underwriting contract, and it was impossible for the company to succeed in the action The appellant company might have other remedies, but they could not succeed in this appeal

Concluding, his Lordship said "I fancy that the palmy days of underwriting have gone, but people will be well advised to be a little cautious in dealing with underwriting and issuing houses"

Lord Justice Greer and Lord Justice Slesser concurred

The appeal was accordingly dismissed

To such low estate had the Main Underwriting Agreement fallen that *The Times* Law Reporter refers to the North British Artificial Silk Main Underwriting Agreement as "one whereby the defendants undertook to procure sub-underwriting contracts" Every trace of guarantee obligation was gone

The case aroused widespread interest The *Financial*

News, in its issue of 21st November, 1929, commented as follows—

UNDERWRITING

Press comment

It is no small sensation that has been caused by the outspoken and pungent words of Lord Justice Scrutton in delivering judgment in the latest underwriting case—North British Artificial Silk, Ltd, against TokenHouse Securities Corporation, Ltd, reported in our last issue Sir Thomas Scrutton when at the Bar had a leading practice in commercial cases and as a judge has had to deal often enough with commercial law and practice He is renowned for his experience and learning and no less for his plain speaking It is with peculiar pleasure that we now find one of our most distinguished judges lending the weight of his authority to the warnings we have given in these columns respecting the evils that have sprung up in connection with underwriting and sub-underwriting, for our readers will recall that we were the first journal to focus public attention upon these matters During the past few months we have reported glaring examples amounting to scandals in connection with the management of the underwriting of shares—in some cases the default resulting in a premature liquidation of the companies concerned It is plain that Lord Justice Scrutton and the Court of Appeal in the observations on the latest case have thought it their duty to animadvert on what "seemed to be a very bad example of the sort of thing that had been going on in the City of London during the last three or four years in connection with underwriting" The Lord Justice also said "I fancy that the palmy days of underwriting have gone, but people will be well advised to be a little cautious in dealing with underwriting and issuing houses" We ourselves in this column, on 19th August, reviewed and commented on the general position as disclosed all too frequently, and it is as well that the Courts have now emphatically marked their sense of the perils that so often beset the path of company flotation in regard to underwriting

The particular case that called forth such strong judicial

comment was, in fact, one in which the underwriting corporation won the day and succeeded in resisting a claim by the plaintiff company The claim was made in respect of an underwriting agreement whereby the defendant corporation undertook to procure sub-underwriting contracts, it being alleged that a number of such contracts were worthless and that the cheques paid by way of deposit on the underwritten shares by defaulting sub-underwriters were dishonoured It was alleged that altogether 155,400 shares of £1 each were left on the hands of the plaintiff company, and had to be re-issued at a heavy loss—the sum of £19,425 being claimed The defendant corporation denied these allegations But they further contended that the plaintiff company's directors having accepted the applications and made allotments thereunder, there could in no event be any claim, and that the defendant corporation thereby were relieved of any legal liability under the agreement The case was tried before Mr Justice Rowlatt, who, we gather, held that this contention was right in law, and that whatever might be the actual truth as to the worth of the sub-underwriting contracts, they had been accepted and acted on by the plaintiff company On appeal, the Court of Appeal has taken the same view As Lord Justice Scrutton remarked "Without any proper consideration, the two directors to whom the task was delegated took the most effective step of approving the sub-underwriters —they allotted the shares" In thus deciding the action, however, the Court of Appeal considered the facts of the case as submitted to them, Lord Justice Scrutton stating the matter thus—

> Of the sub-underwriting contracts in the present case for 345,000 shares of £1 each, those relating to 155,400 were ridiculous, and, if any inquiry had been made by the respondents, they would have found that they were ridiculous One, for 55,000 shares, involving a liability of £55,000, was from a man who had a county court judgment against him for £15 Tokenhouse Securities recognized that it was a ridiculous performance of their contract to put forward applications such as those by declining to claim the

commission of 1 per cent for themselves and 4 per cent for the sub-underwriters in respect of the 155,400 shares

The action of the directors in approving these sub-underwriting applications was criticized, and the Court of Appeal hinted that the company might have other remedies, although they could not in that action succeed against the defendant corporation

We forbear any further comment on the judicial statements above referred to They speak for themselves But we feel bound to refer to a letter from the solicitors acting on behalf of the defendant corporation printed in another column They contend that "this case exemplifies the dangers incurred by a too successful litigant who is thus denied any opportunity of stating his case or refuting in evidence the allegations of his opponent" It is not for a lay journal to discuss this startling proposition The fact remains, however, that the Court of Appeal has stated the facts to be as they appear in the reports of the case, and has based upon them comments in adverse criticism of certain directors of the plaintiff company and of the defendant corporation The public must, of course, assume that the course taken by the Court of Appeal was right and proper We cannot imagine that all proper steps to manage and state their case were not open to the defendants in the action Nor can we agree that proper comment upon judicial utterances must be postponed or withheld unless and until the plaintiff company bring another action After all, the main public interest in the case lies in the general observations of Lord Justice Scrutton, who appears to have felt the desirability of a warning to directors and the public generally in regard to the extent to which "bad" underwriting has prevailed in the City This judicial support strengthens us in the course we have taken hitherto in watching with close and anxious care in this question, and has justified the constant warnings we have ventured to give to the commercial public who look naturally to financial journals for service of this kind It has been suggested in some quarters that some legislative intervention is called for in this matter of

> underwriting We are not of that opinion As Lord Justice Scrutton indicated in his judgment, directors and others concerned have the remedy mainly in their own hands The form of the contracts, the selection of the Underwriters, and the discretion to be exercised before approving applications and allotting shares should be more carefully attended to The evils have now had judicial comment applied to them, and it is to be hoped company officials will pay heed to this welcome indorsement of the advice we have offered from time to time

Inadequacy of the proposed remedy

The *Financial News* endorsed Lord Justice Scrutton's view that directors and others concerned have the remedy mainly in their own hands But it is not quite so simple as that In the case of the new company of the kind in which underwriting scandals have been so flagrant, the first directors are, for the most part, secured by the promoters There is therefore a certain intimacy in the relations of directors and issuing house, and the terms of the underwriting contracts may not be so closely scrutinized as they should be Underwriting is arranged between one group of business men and another If the groups were approximately equal in weight and experience, all would be well Unfortunately, the experience is apt to be one-sided The promoters and issuing house know all that is to be known about underwriting contracts, the directors who are not nominees of the promoters or issuing house, while they may be excellent business or technical men, have often little experience of the intricacies of company flotation

CHAPTER XI

FURTHER CONSEQUENCES OF THE DETERIORATION OF THE MAIN UNDERWRITING AGREEMENT

Difficulty of legal action against defaulting sub-underwriters

Of course it may be said that, if sub-underwriters default, the Company can sue them in the Courts The sub-underwriters have put in an irrevocable application for shares with the sub-underwriting letters, their contract obliges them to take up their due proportion of the residue of shares not allotted to the public, and if they fail to pay the sums due on allotment on these shares, the Company has its legal remedy In the *North British Artificial Silk case*, Lord Justice Scrutton drew attention to the man with a County Court judgment against him who had involved himself in a liability of £55,000 by sub-underwriting 55,000 shares of £1 each This was by no means an isolated case The following, reproduced from the *Financial Times* of 22nd January, 1930, is one of many similar reports—

SUB-UNDERWRITER'S FAILURE

Bankrupt's Frank Admissions

(London Bankruptcy Court Before Mr Registrar Mellor)

The public examination was held yesterday of Mr C W , described as of , who applied to pass upon accounts showing liabilities £11,352 and assets nil

Replying to Mr Ferrars Vyvyan, Official Receiver, the debtor said that since the end of 1918 he had acted as a half-commission man and a secretary to various companies His present position was entirely due to liabilities incurred by undertaking sub-contracts for the underwriting of shares

Early in 1929, when out of employment, he was introduced to one B , who persuaded him to take up the sub-underwriting of shares He did not know that B had been through the Bankruptcy Court, and he had never underwritten shares up to that time In February, 1929, he underwrote a number of shares in Direct Produce (London), and the issue being a success he made a profit of £96

Further examined, the debtor said that in March, 1929, he sub-underwrote 10,990 5s shares in Albanian National Brewery, 3,280 £1 ordinary shares in Waste Food Products, and 48,260 2s shares in Transmotagraph, I td He was unable to take up the shares and judgments for £2,770, £3,357 and £5,170 were respectively obtained against him in respect of the three companies He did not know who was the issuing house in either case, the business having been brought to him by B

The Registrar "Is no inquiry made by any responsible person as to the capacity or solidity of sub-underwriters?"

The Official Receiver "So far as I know, no such inquiry is made Anybody can underwrite or sub-underwrite presuming that they are acceptable to the issuing house"

Debtor "It depends entirely upon the issuing house"

The Official Receiver "It is up to the head Underwriters to make inquiries"

Debtor added that when the first judgment was entered against him he realized that he was hopelessly insolvent He did not defend the actions, and he frankly admitted that he had no justification for undertaking the contracts

The examination was concluded

On 12th March, 1930, the same newspaper commented very fairly—

UNDERWRITING DEFAULTERS

Judgments Leading to Bankruptcy

"Financial Times" Special

Recently the Courts have been heavily engaged in a series of lawsuits in which public companies have sued

defaulting Underwriters In many of these cases the plaintiffs have discovered that a judgment against the defaulters is of no substantial value Several bankruptcies have prefaced or followed the Courts' verdicts

This state of affairs has caused several companies to refrain from pursuing legal redress It has been no uncommon feature of the widespread default to discover that potential defendants have not possessed in pennies the amount that could be claimed in pounds It is no exaggeration to state that at least ten companies are to-day struggling for existence on inadequate capital with no hope for the future

The examiner in bankruptcy has been faced with many stories of underwriting default It seems small consolation for an impoverished company to appear as principal creditor In the majority of cases the possibilities of obtaining even a few pence in the pound are exceedingly remote

Inquiry among many companies reveals a remarkable condition of affairs It can be stated without hesitation that, in spite of all legal proceedings, it is certain that the companies as a whole will not recover more than 10 per cent of the amount owing This, of course, leaves a deficit of several millions

At the present time there are millions of shares lying in "cold storage" *The Financial Times* has knowledge of several companies in which more than half the entire capital has been neither issued nor paid for The knowledge of these facts has played no inconsiderable part in the decline of speculative business

Device of cancellation of allotments to defaulting sub underwriters

Sometimes the company solved the difficulty of having to pursue defaulting sub-underwriters by the simple expedient of cancelling their allotments Take, for instance, the following report given in the *Financial Times* of 14th December, 1929, of the proceedings at the first meetings of the creditors and shareholders of Portland Cement and Limestone Products, Ltd

CEMENT COMPANY LIQUIDATION

Shares Not Taken Up

Receiver's Strictures on Underwriters

A compulsory winding-up order having been made against Portland Cement and Limestone Products, 22, Northumberland Avenue, W C, the statutory first meetings of the creditors and shareholders were held yesterday at Bankruptcy Buildings, Carey Street, W C

Mr E T A Phillips, Official Receiver, reported that the winding-up order was made on 18th November, upon the petition of a creditor The company was registered on 7th December, 1927, with a nominal capital of £500,000 divided into 225,000 £1 7½ per cent Cumulative Preferred, 250,000 £1 8 per cent Participating Ordinary, and 500,000 1s Deferred shares, to carry on business as manufacturers and merchants of cement, lime and building materials of all kinds The issued capital was £131,295

A statement of affairs had been presented showing liabilities £47,313, made up of £23,449 due to unsecured or trade creditors, £22,229 claims for breach of service contract, and other small items The assets were valued at £3,563, apart from any possibility of recovery, nearly £2,000 from the receiver acting on behalf of the debenture holders and the further possibility of recovering something from the directors if it was found later that they had been guilty of any breach of trust

Dealing with the history of the company, the Chairman said Mr W H Nockhold had acted as managing director at a salary of £3,000 per annum He was a director of Associated Engineering and Finance Company (the promoters) and had stated that he had been interested in the cement industry for 17 years In June, 1926, he inspected a property at Fitstone, where he discovered material suitable for the manufacture of Portland cement of the highest quality

On 8th December, 1927, an agreement was entered into for this company to purchase from Associated Engineering and Finance Company the property, together with other properties at Cheddington, Leighton Buzzard,

and Coleford, Dorset, the consideration being £65,000, payable £30,875 cash and £34,125 in shares On the same date an agreement was entered into with the Scottish Finance Company under which that company agreed to subscribe or procure subscriptions at par for 235,000 8 per cent Participating Ordinary and 117,500 Deferred shares

Glowing Prospectus

A prospectus was issued offering shares to the public It referred in glowing terms to the value of the properties acquired, and suggested that there should be £45,000 available for working capital It stated, with reference to the agreement with the Scottish Finance Company, that it provided that that company irrevocably accepted sub-underwriting contracts and cheques from parties specified on an identified list for the whole of the underwritten shares

The issue was not a success, applications for only 25,977 Participating Ordinary and 12,465 Deferred shares being received, with the result that the sub-underwriters had to be called upon

Some of them made default, and as it was found they were unable to fulfil their contract, on the advice of the solicitors to the company, the allotments to those parties were cancelled

This, remarked Mr Phillips, was but another illustration of the scandalous way in which underwriting transactions had been carried on within recent years (Hear, hear)

He said this left the company handicapped for want of money, and in order to meet pressing liabilities £10,660 was obtained on the security of a mortgage over property at Leighton Buzzard and Coleford, and on 8th May, 1929, a 10 per cent debenture for £1,000 was issued to Mr S H Brown Execution having been levied at the works at Leighton Buzzard, the debenture holder appointed a receiver and manager who took possession, and eventually sold the Coleford works for about £11,000 and the property at Leighton Buzzard for approximately £7,000

The failure of the company was the omission of the

> Underwriters to take up their shares He (the Official Receiver) would not like to say whether the company would have been a success if the whole of the capital had been subscribed, but in the absence of adequate funds it was bound to come to grief The accounts showed that the little trading which the company did resulted in a loss of £3,703
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> The appointment of a liquidator will be determined later by the Court, more than one nomination being put forward, but a committee of investigation was selected, and strong opinions were expressed by both creditors and shareholders that the liquidator should take all necessary steps to bring home to those responsible the liability for the misrepresentations (particularly with regard to the underwriting agreements) in the prospectus

Some of the sub-underwriters made default, and "as it was found they were unable to fulfil their contract, on the advice of the solicitors to the company, the allotments to those parties were cancelled" This was very convenient for the defaulting sub-underwriters, but, of course, it reduced the whole business of underwriting to a farce

The protection of sub-underwriters by dummy applications

Even with the most complaisant Board of Directors, however, this device was usually too transparent Issuing houses who had farmed out their guarantee obligations found it politic to look elsewhere for support for their sub-underwriters If these issuing houses were to live, it was a necessity of their survival that they kept their sub-underwriters together A few failures did not hurt them In a time of issue activity like 1927–28, the public were avid for investment and speculation, and there was almost always bound to be a certain number of successes When the failures came along, the best method of protecting sub-underwriters was to use an existing registration that had done no business, or a small company specially formed for the purpose These dummy companies put in applications

for shares sufficient to relieve the sub-underwriters When these shares were allotted, the guarantee obligation of the sub-underwriters was at an end The Main Underwriting Agreement, through the complete contracting out of underwriting to sub-underwriters, had ceased to be a guarantee contract The process was now carried a logical stage further Sub-underwriters, by such applications, were in turn relieved, and the sub-underwriting letter ceased to be a guarantee contract

This practice was very common among a certain class of issuing house, but, of course, it only came to light under exceptional circumstances, such as the later compulsory winding-up of the Company As an example, we can select from published cases the report of the statutory first meetings of the creditors and shareholders of Rayon and General Development Corporation, Ltd This Company was a promoting and underwriting company The immediate cause of its winding up was its liabilities in connection with the promotion of the Yorkshire Artificial Silk Co , Ltd The latter Company was promoted in May, 1928, with a nominal capital of £325,000 A prospectus was issued offering for subscription 225,000 10 per cent Preferred Ordinary Shares of £1 each and 450,000 Deferred Shares of 2s each The Rayon and General Development Corporation underwrote the whole of the Preferred Ordinary Shares about to be issued for a commission of 4 per cent, and an overriding commission of 1 per cent, and in addition undertook to subscribe and pay, within 21 days from the issue of the prospectus, for 225,000 Deferred Shares at par and such number, if any, of the 450,000 Deferred Shares offered to the public that were not applied for by and allotted to the public or sub-underwriters As the Rayon Company

had no specialized knowledge of the business of issuing, it employed the Abchurch Lane Finance Co , Ltd , to act as issuing house Both the Rayon Company and the Yorkshire Artificial Silk Company eventually were wound up compulsorily With this preliminary explanation, we give the report appearing in the *Financial News* of 6th December, 1929—

UNDERWRITERS' FAILURE

The statutory first meetings of the creditors and shareholders of Rayon and General Development Corporation, Ltd , 43 Threadneedle Street, E C , were held yesterday The winding-up order was made on 13th May, 1929, upon a creditors' petition

Mr Naunton (Official Receiver) reported that the company was promoted in December, 1927, by Mr George Wilson Turner, assisted by Mr William Arthur Clark and Mr John Alfred Lofthouse, with a nominal capital of £30,000, divided into 15,000 Cumulative Preference shares of £1 each and 60,000 Ordinary shares of 5s each, 1,750 Preference shares were issued for cash, 10,000 Ordinary shares were issued to Mr Turner as fully paid in consideration of services to be rendered, and 13,250 Preference and 50,000 Ordinary shares were issued to Mr Turner and his nominees as fully paid in anticipation of profits it was hoped to make on the sale of property, which sale never materialized

Liability on Contract

The main object of the company was apparently the underwriting of shares in the Yorkshire company which had been promoted by Mr Turner and Mr Lofthouse Under a contract dated 11th May, 1928, the corporation underwrote 225,000 Preference shares of £1 each, and the unsubscribed portion of 450,000 Deferred shares of 2s each which were offered by the Yorkshire company for subscription The corporation also undertook to apply and pay for in cash 225,000 Deferred shares The consideration to be received by the corporation was a commission of 4 per cent and an over-riding commission of

1 per cent The Yorkshire shares were under-subscribed, and the corporation was liable to take up 127,626 Preference and 265,482 Deferred shares

Sub-underwriting Position

Certain underwriting contracts had been entered into by the corporation, but with a few exceptions the liability of the sub-underwriters was not enforced as the corporation promoted Telford Trust, Ltd (which had a nominal capital of £10 and a subscribed capital of 2s) The object of that company was to apply for and receive on allotment all the unsubscribed shares of the Yorkshire company, and to market them The Telford Trust was unable to pay for the shares Notwithstanding the heavy liabilities of the Telford Trust for shares, the Yorkshire company paid to the corporation underwriting commissions amounting to £11,250, but the Official Receiver was informed that part of that sum was paid back to the Yorkshire company on account of shares

Abchurch Lane Finance Co, Ltd

On the formation of the Yorkshire company an agreement was entered into by that company with the Abchurch Lane Finance Co, Ltd, which contracted to carry through the issue of the Yorkshire company and to apply and pay for in cash at par 325,000 Deferred shares That contract was not complied with, and the corporation appeared to have adopted the liability, although it was unable to pay for the shares

The chairman added that owing to the absence of books and the neglect of Mr Turner to lodge a statement of affairs, it was impossible to furnish any reliable information concerning the assets and liabilities, but the assets apparently consisted of various shares of little value, and other items valued at £1,449, while the liabilities exceeded £87,000, inclusive of £40,842 due to the Vendomatic, Ltd, and £18,650 to Textile and General Engineering Co In addition, the corporation might be found to be liable to the Yorkshire company in respect of unpaid calls

The liquidation was left in the hands of the Official Receiver

Share pools

The Telford Trust, registered with a nominal capital of £10, divided into 200 shares of 1s each, of which two shares of 1s each were subscribed and paid up, applied for a sufficient number of shares to relieve the sub-underwriters In the case of the Yorkshire Artificial Silk Company, the device, although it saved the sub-underwriters, failed to save the company In many other instances it was successful These dummy companies disposed of the shares later on the market They were used extensively, for example, in many of the 1928 gramophone issues The procedure was as follows When it was seen that an issue was going badly, the dummy company put in a large application To complete the relief of sub-underwriters, and to minimize the risk of eventual failure of the operation, the vendor was generally persuaded to use most of his cash consideration to apply for shares The issuing house or promoters, as "evidence of good faith" when prevailing upon the directors to allot to the dummy company, more often than not agreed to take a substantial part of their fee in shares Thus, a sufficient number of shares to control the market could be pooled

Simultaneously with these manoeuvres an outside broker was approached In 1928 there were about a dozen of these gentlemen who specialized in this kind of transaction, and some of them made substantial profits out of it The pool gave the outside broker options on the shares at rising prices For instance, options on a 5s share might start at 3s or 3s 6d and rise to 7s or 8s The outside broker then commenced a publicity campaign These campaigns were beautifully organized The Press is rightly averse to its general columns being used for share pushing, but

these brokers could guarantee that every day for, say, a two months period there would appear in a London daily newspaper some mention of the company in whose shares they were operating The mention might be in the society columns, in the gossip page, in the general news items, in the City section The editors, and even the journalists responsible, rarely knew how they were being used The "guinea pig" director earned his fee

An active market was made in the shares The outside brokers bought and sold sufficiently to ensure a large number of markings every day and give the appearance of great Stock Exchange activity Quotations were advanced step by step The speculative type of investor was soon attracted, and in many cases, 1s shares were run up to 10s or 12s, 2s shares to 18s or 20s, and 10s shares to several pounds On any recession the operators supported the market When they had disposed of the shares they held under option, they withdrew their support and as a rule the market collapsed

The pooling of shares by Underwriters and sub-underwriters who have had to accept allotments in terms of their contracts, and the subsequent sale of these shares on the market by trustees on behalf of the pool, has long been recognized as a legitimate operation When an issue goes badly, the market in the shares is naturally weak Apart from the unfortunate publicity of failure, the Underwriters and sub-underwriters, except for their firm applications, are not permanent holders There is always therefore a large number of shares hanging over the market In other words, the supply exceeds the demand If Underwriters and sub-underwriters were to throw their shares on the market, quotations would be unduly depressed, the *bona fide* applicants for shares would suffer, and

the Underwriters would lose money The obvious remedy is for Underwriters and sub-underwriters to pool their shares and ration the market The lines of a pooling agreement are well established Several excellent forms in general use are given in Palmer's *Company Precedents*, Part I, Chapter II The usual procedure is for the shareholders concerned to convey their shares into the names of trustees The trustees sell the shares at their discretion, and, after paying expenses, divide the proceeds among the members of the pool If the trustees are given power to *buy* shares in the company, it is usually under strict conditions A pool of this kind performs a useful function, but very different in character were many of the 1928 pooling agreements to which we have referred They were constituted for the express purpose of rigging the market Legally they may have been watertight Morally, they were often nothing more than conspiracies to defraud the public

The springing up of underwriting companies with no resources

A further result of the deterioration of Main Underwriting Agreements was the springing up of small financial groups formed to get underwriting and earn the commission They usually combined this activity with the business of issuing Between 1920 and 1928 a considerable number of so-called issuing houses were registered with ridiculous capital Again confining ourselves to published reports, we give as an example the following extract from the *Financial News* of 14th December, 1929, relating to the Fordham Trust, Ltd This Company with a capital of £500 underwrote in one instance alone 900,000 shares of 10s each

BIG UNDERWRITING CONTRACTS

£500 TRUST'S FAILURE

Under the compulsory liquidation of Fordham Trust, Ltd , York Road, King's Cross, N , the Official Receiver,

who is also acting as liquidator, reports that the total liabilities amount to £40,508 and the assets are valued at sufficient to yield a surplus of £8,803 after payment of all debts The issued capital is 500 Ordinary shares of £1 each

The company was formed in August, 1928, to carry on business as company promoters According to the books, a profit of £6,586 was made out of the promotion and issue of the prospectus of United Match Industries, Ltd , but there appears to be a liability of £5,520 for unpaid calls on Preference shares taken up by the Trust

In October, 1928, the Trust entered into arrangements to acquire certain businesses with the object of selling them to Gradiophone Cabinets, Ltd , which was formed with a capital of £125,000

Parent Coal Carbonization

The Trust was also engaged in the promotion of Parent Coal Carbonization Trust, Ltd , and Automatic Records Player, Ltd The Trust was to receive a fee of £30,000 for promotion services in connection with the Parent Coal Carbonization Trust, but only obtained £18,500 in respect of the expenses, and paid £500 as commission for the introduction of the business The Trust underwrote 900,000 8 per cent Participating Preference shares of 10s each for commissions totalling £25,000 That sum was received and cheques for £26,164 were drawn in favour of the Parent Coal Co in respect of shares The public issue was not a success, and the Parent Coal Co is now seeking to make the Trust liable for the amount of the calls on those shares

Automatic Records

As consideration for the promotion of Automatic Records Player, Ltd , the Trust was to receive £12,000 for expenses and a fee of £1,000, but has only received £4,000 The whole of the issue of 850,000 shares of 2s each was underwritten by the Trust at a commission of £4,250, which was immediately repaid to the company as payment in full of 42,500 shares The public issue was

not a success, and the company is endeavouring to make the Trust liable for £28,329 in respect of calls on 473,230 shares

In the opinion of the Official Receiver the failure is directly attributable to mismanagement on the part of the directors in that no proper provision was made for adequate working capital to enable the company to carry out successfully an ambitious programme, and further, the directors committed the company to contracts and underwriting agreements which it was not in a position to carry through

Gravity of the position in view of the rise of a new post war investing public

These examples of the methods of the decade to 1930, made possible in large measure by the deterioration of the guarantee element in Main Underwriting Agreements, could be continued almost indefinitely We have selected only a few typical examples reported publicly in the closing months of 1929 and the early months of 1930 Readers will recollect many other instances The position revealed was a most serious one There had been promotion scandals before the War, but conditions then were very different Issues were neither so large nor so frequent Investors, as a whole, were better prepared to lose their money, and, if they speculated, they usually took care to get sound advice first After the War there was a great broadening of public interest in Stock Exchange matters Last century wealth was concentrated in comparatively few hands The twentieth century has seen a steadily increasing diffusion of money among all classes Before the War the small investor was content to put his capital in the Savings Bank, his Building Society, or in Corporation Loans One of the most notable post-war financial developments was the interest he began to take in the shares of public companies A completely new investing public made their appearance They were not nearly so well informed,

and were much more inclined to venture their money directly on their own fancy The City was presented with a wonderful opportunity This new and great public were clamouring to invest The needs of industry and trade for capital had never been greater The issuing house, as the intermediary that would investigate the demand for capital, present that demand, supported by its own guarantee, to the public, and so make the demand effective, had become an urgent necessity But the City failed to rise to the opportunity

In this and the preceding chapter we have seen examples of what too often occurred This young and impetuous public had picked up the jargon of speculation They were immensely interested in new enterprises, in fresh inventions, in products that had yet to be marketed They liked high-sounding names on the Boards of their companies, and they were given them They required letters in the prospectus setting out expert opinions on the new invention or product, and letters were provided They expected the issue to be fathered by a City financial house, and the promoters supplied themselves with financial concerns with the highest sounding names Above all, they examined the prospectus to see that the issue was underwritten, for they had grown to appreciate the significance of underwriting, and they saw the names of the Main Underwriters They were satisfied, and poured out their hard-earned savings Too late and too often they discovered that the imposing façade of the new issue concealed a hollow sham

All right-thinking people were aroused to action by the scandals that developed A powerful Committee to report on the necessary amendments to Company Law sat in 1925 and 1926 As a result of their recommendations, a new Act was drafted and came into force

on 1st November, 1929, as the Companies Act, 1929 On 5th November, 1929, the Macmillan Committee on Finance and Industry was appointed In 1930, the Stock Exchange revised its rules Many professional bodies made recommendations, and, generally speaking, the whole subject was ventilated We shall now examine the remedies proposed and consider how far they are effective

CHAPTER XII

THE COMPANY LAW AMENDMENT COMMITTEE 1925-1926 AND THE COMPANIES ACT, 1929

THE Company Law Amendment Committee, under the chairmanship of Mr Wilfred Greene, K C , sat in 1925 and 1926 to consider and report the amendments that were desirable in the Companies Acts, 1908 to 1917 Their recommendations formed the basis of the Companies Act, 1929 The Committee sent out a General Memorandum, giving the headings under which they desired opinions and evidence, to a large number of individuals, corporations, and institutions, and they heard many representative witnesses The only reply that dealt at any length with underwriting was that put in by the Senior Official Receiver in Companies' Liquidation, the late Mr H C Burgess He broached the subject under the heading of matters that ought to be disclosed in the prospectus—Sect 81 of the 1908 Act The relative paragraph of Mr Burgess's Memorandum and the evidence he gave on it are quoted *in extenso* They are interesting in themselves, but they are of particular importance as showing the attitude of this very powerful and representative Royal Commission to the subject of underwriting and its abuses—

The Senior Official Receiver's Memorandum and Evidence

Appendix B Memorandum by the Senior Official Receiver in Companies' Liquidation

Sect 81 (1*h*) Some restrictions upon the practice of getting irresponsible Syndicates to underwrite shares which are being offered to the public, appear to the Official Receiver to be desirable

Particulars of all underwriting contracts should be stated in prospectus Capital of underwriting company or syndicate should be adequate

These may be effected by providing that particulars of all underwriting contracts, with names, addresses, and amounts, shall be stated in a prominent manner in the prospectus, and that no Company or Syndicate shall be allowed to undertake any underwriting unless it has a substantial cash subscribed capital, and is, in the opinion of the directors and promoters, in a position to pay for the shares underwritten, if called on

The Committee are no doubt aware of the French method of preventing an issue to the public, or dealing on the Stock Exchange, until a Government certificate as to value has been issued

In Evidence

415 (Chairman) I was much interested in your suggestion as to underwriting Is it your experience that irresponsible syndicates are in the habit of underwriting shares with the result that the Company suffers some loss because the underwriters cannot perform their contract?—Yes

416 Is it a common thing?—Yes

417 Has that failure to perform underwriting contracts resulted in Companies having to go into liquidation or something of that kind, or how has it operated? —The most common experience is that the small subscription by the public is used An allotment is made which ought never to have been made The money that ought to come in from the underwriters does not come in so that the small amounts subscribed by the public are used for purposes which are evidently not in the interests of the Company and the Company cannot succeed on that subscription

418 Have you had experience of several instances of that taking place?—Yes, in which a man who is

controlling several Companies has some of these come in and do the underwriting, he being a promoter perhaps of the new Company

419 Of course, it might be possible to insist that the names and addresses and amounts in the case of underwriting contracts should appear in the prospectus, but the practical difficulty I feel about it is, that that of itself, except to the extremely vigilant, probably would not be very much of a safeguard, and I see difficulties about the suggestion of having some sort of guarantee on the face of the prospectus as to the solvency of the underwriting syndicate or Company I notice you have suggested that there must be a substantial cash subscribed capital, that, of course, would be rather a difficult matter to legislate for On the other hand, it might be a hardship if you were to make directors liable in the same way for the solvency of the underwriting syndicate Those are the sort of dangers I see in any proposal of the kind?—I do not think I could suggest that the balance sheet of the underwriters should go to the subscriber

420 Of course, it would not be practicable to put that in a prospectus?—Not to set it out certainly

421 The obligation upon the director is one that could only be enforced by penalty One has, of course, to avoid anything which is going to penalize the honest man for the sake of catching one or two rogues That is the thing one has to avoid?—I think these things get noticed If the names appeared of the underwriters and they were known to be connected with the promoter of the concern I think that would be noticed in the financial articles of the daily papers I have seen references to such things sometimes

422 To that extent the mere mention of the name and the amounts in the prospectus you think would

afford, at any rate, some safeguard?—I think so I think the financial papers would take it up

544 (*Mr Brand*) May we go back on the points we have mentioned, as if so, I would like to ask a question on Sect 81 Does Mr Burgess maintain his suggestion that in all underwriting contracts all the names and addresses of the various Underwriters should be stated?—Yes, I think they ought to make the fullest disclosure

(*Mr Brand*) As far as my experience goes, it would be quite impossible

(*Mr Mortimer*) In the same way that it is done by substantial banks

545 (*Mr Brand*) You get hundreds of names, and they could not all be got?—Yes, but it might be arrived at in some other way, it might be left to somebody else to certify

546 In the great mass of underwriting done in the City no question of difficulty ever arises in this connection?—The difficulty in these cases is the unsubstantial underwriter I want him disclosed, because then he will not be brought into the case, and they will so get a substantial underwriter who will make good if the duty is put upon him

547 (*Mr Campbell*) Are not those cases very few? —No, not in my experience

(*Mr Andrewes-Uthwatt*) There was a case in which an underwriter could not pay up a matter of £10

(*Mr Brand*) If you did this, you would practically stop underwriting as it exists at present It would have to take some other form

(*Mr Mortimer*) You would have to get one big house to do the whole thing, and then split it up, it would be very difficult

(*Mr Harold Brown*) It is that very question which led to the practice Underwriting was done by hundreds of people When the Companies Act was passed the question arose, "Are the underwriting contracts material?"—we had to set out the dates and parties To get over that, the practice began to make a top underwriting contract with one Company, and then that was covered by hundreds of sub-contracts That has been abused Sometimes the top Underwriter is a Company which has not the financial capability of carrying out the obligation If it has substantial sub-underwriters behind, it does not matter, but it may have very unsubstantial sub-underwriters behind it, but these cases are only one in a thousand

(*Mr Andrewes-Uthwatt*) Promoters will not run the risk of having unsubstantial underwriters and having to pay the initial advertising and other expense

(*Mr Campbell*) I think there have only been six cases where the underwriters have been unsubstantial

548 (*Mr Wilton*) I should like to ask whether Mr Burgess approves of the modern practice of directors acting as underwriters in connection with the Companies in which they are concerned as directors?—I do not know that I have found any difficulty in it I cannot appreciate where any mischief could arise if you have a responsible underwriter

It is hard to credit Mr Campbell's statement that in the years preceding 1926 there had been only six cases when the Underwriters had proved unsubstantial In the years succeeding 1926 he might have found a good many every month

Mr A F Topham's view

Mr A F Topham, K C, made a similar suggestion to that of the Senior Official Receiver In his reply to the Committee's General Memorandum he wrote

"Underwriting is, in my experience, sometimes undertaken by bogus Companies with no sufficient assets The prospectus should, I think, state the amount of capital paid up in cash of the underwriting company" But the Committee decided to do nothing Their recommendation in regard to prospectuses commenced as follows—

The Committee's decision No change

PROSPECTUSES

38 The existing law with regard to prospectuses properly so called is in our opinion on the whole satisfactory No evidence was given before us to justify any relaxation of the law in this respect except in one minor particular The statutory requirements are strict and in some cases no doubt may prove unnecessarily onerous, but we consider that the public should continue to receive the protection which it at present enjoys

The only other references to underwriting in the evidence before the Committee were in relation to the rate of commission that should be permissible, and to the necessity of disclosing the amount paid in a Company's balance sheet

The Committee's remedy— the minimum subscription

The statutes have left underwriting very much alone In the Companies Act, 1929, there are 385 sections One of these deals with underwriting The law has always taken quite another view of the methods by which a Company should ensure that it has sufficient capital for its requirements The legal principle has been the method of minimum subscription In an earlier chapter we have noted how the principle of the minimum subscription was reduced to a mere formality The most fundamental change made in the law by the 1929 Act was the new provision of Sect 39 regarding the minimum subscription This was the Legislature's

remedy for the abuses and scandals that we have described Sect 39 provided that the minimum subscription on which the Company could proceed to allotment was the amount stated in the Prospectus as sufficient, in the opinion of the directors, to provide for the full purchase price of any property acquired, for all preliminary expenses, underwriting commission and brokerage, and for working capital The section read—

ALLOTMENT

Companies Act, 1929, Sect 39

39 (1) No allotment shall be made of any share capital of a company offered to the public for subscription unless the amount stated in the prospectus as the minimum amount which, in the opinion of the directors, must be raised by the issue of share capital in order to provide for the matters specified in paragraph 5 in Part I of the Fourth Schedule to this Act has been subscribed, and the sum payable on application for the amount so stated has been paid to and received by the company

For the purposes of this subsection, a sum shall be deemed to have been paid to and received by the company if a cheque for that sum has been received in good faith by the company and the directors of the company have no reason for suspecting that the cheque will not be paid

(2) The amount so stated in the prospectus shall be reckoned exclusively of any amount payable otherwise than in cash and is in this Act referred to as "the minimum subscription"

(3) The amount payable on application on each share shall not be less than 5 per cent of the nominal amount of the share

(4) If the conditions aforesaid have not been complied with on the expiration of 40 days after the first

issue of the prospectus, all money received from applicants for shares shall be forthwith repaid to them without interest, and, if any such money is not so repaid within 48 days after the issue of the prospectus, the directors of the company shall be jointly and severally liable to repay that money with interest at the rate of 5 per cent per annum from the expiration of the forty-eighth day

Provided that a director shall not be liable if he proves that the default in the repayment of the money was not due to any misconduct or negligence on his part

(5) Any condition requiring or binding any applicant for shares to waive compliance with any requirement of this section shall be void

(6) This section, except subsection (3) thereof, shall not apply to any allotment of shares subsequent to the first allotment of shares offered to the public for subscription

Companies Act, 1929, Para 5 of Part I of the Fourth Schedule

Paragraph 5 of Part I of the Fourth Schedule of the Act to which reference is made in the first subsection of Sect 39, runs—

PART I

Matters Required to be Stated in Prospectus

5 Where shares are offered to the public for subscription particulars as to—

(1) The minimum amount which, in the opinion of the directors, must be raised by the issue of those shares in order to provide the sums, or, if any part thereof is to be defrayed in any other manner, the balance of the sums, required to be provided in respect of each of the following matters—

(*a*) The purchase price of any property purchased or to be purchased which is to be defrayed in whole or in part out of the proceeds of the issue,

(*b*) Any preliminary expenses payable by the company, and any commission so payable to any person in consideration of his agreeing to subscribe for, or of his procuring or agreeing to procure subscriptions for, any shares in the company,

(*c*) The repayment of any moneys borrowed by the company in respect of any of the foregoing matters,

(*d*) Working capital, and

(ii) The amounts to be provided in respect of the matters aforesaid otherwise than out of the proceeds of the issue and the sources out of which those amounts are to be provided

To make the picture complete, we quote from the Report of the Company Law Amendment Committee, 1925–1926—

E Minimum Subscription

The Company Law Amendment Committee's recommendations and proviso

42 The existing law as to minimum subscription has become in practice useless owing to the low minimum which is usually fixed in Articles of Association We consider that an alteration in the law should be made so as to bring it as nearly as possible within the original intention of the legislature

Then followed the recommendations that were put into effect by Sect 39 The concluding sentence ran—

If this recommendation is adopted, Sect 85 (1) should be amended so as to make equivalent to payment a cheque given and received in good faith where the directors have no reason to believe that the cheque will not be met

This proviso was likewise given statutory force by Sect 39

The section provided a much-needed reform It

marked a great advance, or rather it brought us back to the spirit of the 1862 Companies Act No company should go to allotment until its minimum capital requirements are assured The statutes tackle the problem of the provision of capital from quite a different angle from that discussed in this book The new provisions may be as far as the statutes can go The Company Law Amendment Committee were certainly of that view, but do the new provisions ensure that the Company will have adequate capital? The Companies Act, 1929, in the opinion of its sponsors, cut the Gordian knot These sponsors said, in effect You City men have found the guarantee provided by underwriting to be an essential part of company finance That may be so, but we can take no cognizance of the practice beyond fixing the rate of commission that may be paid for such services and ensuring that the rate of commission and the parties to the Main Underwriting Agreement are disclosed in the Prospectus There have been bad breakdowns in underwriting Recently, companies have been deprived of many millions of pounds through the default of Underwriters These companies have consequently had insufficient capital and have been forced into liquidation We are going to ensure that these things do not happen again by fixing the minimum subscription on which the directors may proceed to allotment If the public do not subscribe the minimum subscription, we have no objection to your Underwriters coming to the rescue If they, too, fail, the shareholders must have their money back, there is to be no allotment to anyone Underwriting is your affair, not ours We have set you the problem —the minimum subscription must be provided before the Company can proceed to allotment You must put your own house in order Underwriting practice has

The minimum subscription an ultimatum to the City

been shown in the past few years to be in some respects defective If you want your company flotations to go on, you had better set about remedying the defects at once That is your problem, not ours

Where Sect 39 fails

There would be a considerable amount of truth in this view if the section were watertight, but that is precisely what it is not On the express recommendation of the Company Law Amendment Committee—made after taking much evidence that makes very interesting reading—the first subsection of Sect 39 states—

> "For the purposes of this subsection, a sum shall be deemed to have been paid to and received by the company if a cheque for that sum has been received in good faith by the company and the directors of the company have no reason for suspecting that the cheque will not be paid"

Allotment practice

Consider for a moment the usual practice of allotments in the case of a public issue The Prospectus states that the subscription lists will open at a certain time, and, as a rule, that they will close in two or three days For instance, at the head of a Prospectus issued on 5th September, 1933, there would appear the words—

"The subscription list will open on Tuesday, the 5th day of September, 1933, and will close on or before Thursday, the 7th day of September, 1933"

The three days' interval is just a tradition It is many years since an industrial issue, at any rate, remained open a second day In practice, the lists are only allowed to be open a very few hours, for it has been found that investors are quick to discover if an issue is not going well, and to withdraw their applications Applicants may be divided into two classes—stags and

genuine investors Stags are persons who, if they think well of an issue, put in large applications, often in many different names, in the hope of making a quick profit when dealings in the shares commence on the Stock Exchange Many people consider them a nuisance, but in some ways they perform a definite economic function The permanent investor is often slow at making up his mind He reads the Prospectus, but he is not sure He may like to consult his stockbroker or his banker before he commits himself, and by that time he is too late Or he may not see the Prospectus at all, although, when the company is later brought to his attention, he appreciates that the shares will make an excellent holding The stags step into the breach They give the issue a good send-off They help to make an active market in the shares If the permanent investor has to pay more for his holding, he may console himself with the reflection that if it had not been for the stags, and the success they gave the issue, he might never have heard of it at all But the stags are out for a quick profit If they find on the morning of the issue that subscriptions are hanging fire, they cancel their applications at once

Similarly, if it comes to the knowledge of the genuine investor that subscriptions are coming in slowly, he is equally anxious to withdraw his application, for he realizes that a large proportion of the issue will probably be left with the Underwriters and that there will be a reasonable chance of obtaining shares at a discount after permission to deal has been given by the Stock Exchange

On the morning of an issue, therefore, unless the public response has been immediate and overwhelming, the directors are in a dilemma In nine cases out of ten it is politic to close the lists in an hour or two

and to proceed to allotment If the public have not subscribed in full, the residue is distributed among the Underwriters and sub-underwriters Then up comes the question of cheques 'Presumably the public, when they applied for the shares, could afford to pay for them, but what about the sub-underwriters? In all the scandals of 1928 and 1929, how often could it be said that directors, in the words of Sect 39, accepted cheques, "suspecting that the cheques will not be paid"? Even if, in certain cases, they did accept cheques suspecting that they would not be paid, how is that fact going to be established? To prove bad faith on the part of a director under these circumstances would be tantamount to proving conspiracy with intent to defraud, an extraordinarily difficult charge to substantiate Who is sufficiently interested to undertake the costly, and arduous task of suing?

One must have sympathy with the position of the directors on the day of the issue They have been presented by their issuing house, whom they presumably trust, with a list of sub-underwriters These sub-underwriters are mostly complete strangers to them What will the directors do? They have no option but to go to allotment In all probability, they will allot to the sub-underwriters

But in practically all the scandals of 1928 and 1929 the repudiated cheque was the centre-piece Underwriting defaults took various forms, but in almost every case, so far as the Company was concerned, the immediate cause was to be found in the cheques paid in by the sub-underwriters The sub-underwriters had handed over with the sub-underwriting letters their cheques for the sums due on application, but when the Company went to allotment and these cheques were presented, they were not met

The proviso to the first subsection of Sect 39, that cheques received by the directors in good faith are to be regarded as cash for the purposes of allotment, appears, therefore, to bring us back exactly to where we were before the Act was passed It is difficult to see how, by itself, Sect 39 is going to be of material use, when the next boom comes, in preventing a recurrence of many of the malpractices we saw a few years ago

Remedies proposed

Since 1929 much controversy has raged round the section, for as soon as the Act was put on the Statute Book it was appreciated that the new provisions went very little way towards preventing underwriting default One school has urged that Underwriters' cheques should be cleared before the Company goes to allotment, that is to say, in practice, before the day of issue We have already discussed this point of view If it were put into effect, underwriting contracts would become much more than guarantee contracts Underwriters' applications would all be firm applications The circle of reputable sub-underwriters would contract The idea seems to be impracticable Even an Underwriter at Lloyd's is only asked to deposit security, at most, for the amount of premium income on the risks he underwrites If he had to put up security for the full amount of every risk covered, he would soon go out of business

Another school, among whom is numbered Mr A F Topham, K C, advocates that a way out may be found if the directors proceed to allot to the public as soon as they think fit, but do not allot to the Underwriters and sub-underwriters until sufficient time has elapsed for their cheques to be cleared and met If, on the other hand, the directors feel that they must allot generally, they could still make it clear that

allotments to sub-underwriters are conditional on the cheques of the Underwriters being met The sub-underwriters have agreed that their applications are irrevocable They cannot, therefore, withdraw them on the ground that the issue has not been a success

It might seem that if either of these courses—partial allotment or conditional allotment—were adopted, directors would safeguard themselves and their companies But there is a serious practical difficulty in the way The Committee of the Stock Exchange has found it necessary to make strict regulations covering allotments and the issue of allotment letters, and conformity with these regulations is a condition precedent to the grant of permission to deal No conditional or partial allotment would be tolerated by them The cure might well prove worse than the disease The Rules of the Stock Exchange lay down that all Letters of Allotment, in accordance with the specimen submitted to the Committee, must be posted *at the same time*, and a declaration that they were so posted is required

Special Committee of the Association of British Chambers of Commerce, 1933

The Special Committee of the Association of British Chambers of Commerce appointed to consider the desirability of amendments to the Companies Act, 1929, reported in August, 1933, as follows—

Underwriting, etc

The Committee recommend that directors should be required to take all reasonable steps to ensure that their Underwriters are good for their commitments, and that allotment letters should not be posted until cheques received with application forms and from Underwriters had been cleared

The second paragraph of Sect 39 (1) reads as follows—

"For the purposes of this subsection, a sum shall be deemed to have been paid to and received by

> the company if a cheque for that sum has been received in good faith by the company and the directors of the company have no reason for suspecting that the cheque will not be paid "

The Committee recommend that the second paragraph of Sect 39 (1) should be amended to read as follows—

> "For the purposes of this subsection a sum shall not be deemed to have been paid to and received by the company, until the cheque or cheques have been cleared "

Earlier in the chapter we have considered the dangers inherent in the postponement of allotment It must be remarked that if conditional or partial allotments, or the postponement of allotments altogether until cheques are cleared, are the only protection against bad underwriting that companies have, the great principles of underwriting—of the guarantee contract—have come to a sorry pass

Limitations of statutory enactment

The law considers it has done all it can It is as stringent and as comprehensive in most respects as that of other countries It could certainly be strengthened Even the 1929 Act has been framed with what many people consider an undue regard for the principle that it is undesirable to place obstacles in the way of legitimate business The short extract from the Minutes of Evidence before the Company Law Amendment Committee given earlier shows this principle at work The law is necessarily rigid It is not easily altered to meet changing conditions Our legislators have felt that it is no use trying to make the Companies Act a complete structure that will provide for every contingency The world of companies and finance is instinct with life, expanding in some directions, contracting in others, growing, decaying, continually taking new forms Flexibility and freedom are

essential to it A prudent law-giver must, therefore, ponder long before he puts on the Statute Book any enactments that will restrain it unduly

The motives behind our company legislation have changed little since 1862 We have traced the growth of the joint-stock idea The original Companies Acts merely extended the principles of partnership inherent in the old joint-stock companies They gave the company registered under them the advantages of limited liability and of shares easily transferable The shareholders as partners in the concern were from time to time to elect from their body a committee of directors who would manage the business on their behalf The Acts contented themselves with laying down certain rules governing the formation, the life, and, if and when necessary or desirable, the demise of the company

Company developments since 1862

Conditions have changed since 1862 Management has become almost completely divorced from ownership So far as the shareholder is concerned, a company now springs into life like Minerva, fully armed, and the general public are invited, usually through an advertised prospectus, to subscribe for shares The next step is the creation of a market in the shares on the Stock Exchange The whole emphasis and tempo of company flotations have altered The first shareholders are confronted by the ready-made Board of a ready-made company The immediate concern of all interested in the issue, including the shareholders, is to ensure the ready marketability of the company's shares The Stock Exchange has assumed an importance undreamt of fifty years ago

The law feels that it has done its best for the protection of the public We have seen that even the new provisions relating to the minimum subscription are not all they appear to be The high hopes of many

people that the 1929 Act would put an end to all malpractices have not been justified by the event The experience of the past few years has thrown up the inherent weakness of statutory enactment as a shield against abuse or fraud or even defective practice Let us see what the Stock Exchange, this great new factor in company life, has done and is capable of doing to protect the investor and remedy these abuses

CHAPTER XIII

THE STOCK EXCHANGE

Importance of the Stock Exchange

TIMES have altered since the days of Change Alley, when stockjobber was a word of not unmerited reproach The Companies Acts gave the Stock Exchange a new importance As companies grew in size and number, as wealth spread and new classes of investors arose, the marketability of shares became a factor of ever-increasing weight in company affairs In principle the business of a stockbroker is to buy and sell shares on behalf of clients, in practice he is something more than an agent The reason is twofold In the first place, from the point of view of clients, he has become a specialist in company affairs and is looked to for advice In the second place, from the point of view of companies, his Committee has always reserved the right to decide whether or not dealings in a company's shares will be permitted

Function of the stock broker

The world of investment—its extent, its methods and, in some degree, its ideals—has undergone an almost complete change in the past thirty years and in particular since the War As a result, new duties and new functions have been thrust on the stockbroker On the Continent, where capital issues are in the hands of the banks, the investor goes to his banker for advice In this country, he goes to his stockbroker The stockbroker was not always the best adviser His horizon, by the nature of the organization of dealings, was too often bounded by next account day But the stockbroker of to-day, with his statistical department and his research department, his monthly and quarterly circulars to clients giving a view of current trends and

investment possibilities, his periodical scrutiny of and advice on clients' lists of holdings, has in many cases risen to the occasion

The change from the old to the new is not yet complete, but sufficient has been accomplished to give our stockbrokers a status they enjoy in no other country It is only a matter of time before the logic of events will compel them to reorganize their constitution, abolish privilege, and establish a minimum standard of knowledge and competence The Stock Exchange is already in many respects a semi-professional body Its best members are actuated by the true professional spirit The next step should be to follow the example of the other professions, make entrance to membership a matter of qualification, and discipline conduct

Business on the Stock Exchange depends on the confidence of investors Anything that undermines that confidence reacts on members It was the excellent dealing machinery of the Stock Exchange that made possible, and in many cases provided the incentive for, the scandals of 1928 and 1929 The events of 1929, culminating in the Hatry crash, gave investors a fright They probably felt that much of the misuse of Stock Exchange machinery had only been possible with the connivance of certain members Their belief in the capacity and, in some cases, the good faith of stockbrokers to advise was shaken The eagerly-expected Companies Act of 1929 did not solve the problem of the prevention of abuses, and so reassure investors

Power of Committee of the London Stock Exchange

At last the Committee of the London Stock Exchange was shaken out of its conservatism It remembered the second great factor that has given its members prestige—the power of the Committee itself to grant or refuse permission to deal in shares If the promoters of a company comply with the formalities laid down

by the statutes, the Registrar of Joint-stock Companies cannot refuse incorporation The Stock Exchange, however, is a private body responsible to no one but itself It is not rigidly bound by precedent or by a written constitution It can make rules and yet exercise judgment in the application of them It can alter or modify its attitude to meet changing conditions When a company goes to the Committee for permission to deal, the Committee may refuse the application or it may make conditions The necessity for a quotation is a matter of such primary importance to the modern company that the company has no option but to satisfy any conditions that the Committee cares to impose The Committee is potentially a far more effective source of protection to the investor than the law

Permission to deal—the 1930 sub-committee

It used to be a simple matter to obtain permission to deal After the War certain further regulations were made, but they were not stringent enough The events of 1928 and 1929 compelled the Committee to realize that, if it were resolute in withholding or withdrawing its dealing facilities from undesirable flotations, it could paralyse the activities of the unscrupulous promoter, issuing house, or Underwriter In 1930 it appointed a sub-committee to make a complete revision of the rules and regulations governing its policy in allowing securities to be dealt in under its authority

One of the first matters to which the sub-committee directed its attention was the scandal of weak or dishonest underwriting It could not ensure that underwriting contracts were properly drawn, but it could see that the whole facts of every case were placed before the Committee when permission to deal was sought

The sections of the Regulations for Obtaining Permission to Deal in New Issues that relate to

Rules and Regulations of the Stock Exchange, 1931 Appendix 34A

underwriting, put into force in 1930 as a result of the sub-committee's recommendations, were as follows—

Appendix 34A

Regulations for Obtaining Permission to Deal in New Issues (*Rule* 159)

8 List of allottees or present holders—name, address, and holding (when required)

9 In all cases other than Government and Municipal Loans, and issues by Statutory Boards, Companies incorporated by Special Act of Parliament and other similar authorities, whether the issue is made by Prospectus or otherwise, particulars of any underwriting or commission must be disclosed and a copy of the underwriting agreement and of sub-underwriting letter, if any, together with (if required) a list containing the names, addresses, and descriptions of sub-underwriters and the amount sub-underwritten must be lodged with the Department

In every case other than an issue such as a Government Loan, not only is the underwriting commission to be disclosed, but a copy of the Main Underwriting Agreement and of the sub-underwriting letter, with particulars of the sub-underwriters, must be lodged with the Share and Loan Department The Department also requires a list of all allottees and full details of any shares under option

Share introductions —a disguised form of underwriting

The next matter with which the sub-committee dealt was the question of share "introductions" Introductions may be regarded as a disguised form of underwriting The procedure is as follows A Company desires to make an issue of shares Instead of going to the considerable trouble and expense of a public issue, the Company "places" the shares privately, usually through the agency of a firm of stockbrokers The brokers, after investigating the issue, recommend it to

their clients and connections, advising them that it is proposed to obtain permission to deal The clients and connections apply for the shares in the knowledge that the market will be very carefully looked after and that there should be a premium on the shares when dealings begin The process is analogous to Underwriting The brokers take the place of the Main Underwriters, the clients and connections take the place of the sub-underwriters Not infrequently, however, to make assurance doubly sure, the issue is also underwritten When application is made to the Committee for permission to deal, the Committee calls for all the information that it considers necessary in connection with the Company and the issue, and requires the Company to advertise in at least two newspapers a Prospectus "for information only" This Prospectus is not an invitation to apply for shares, it is the Committee's method of ensuring that particulars of the Company and of the issue are made publicly known

This method of company finance is legitimate and often convenient The issue may be a small one that could ill stand the expenses attendant on a public issue which, in the case of an issue of less than £200,000, may be out of all economic proportion The company may be a well-established concern that finds the "introduction" of new shares a convenient way of avoiding a great deal of trouble The "introduction" may be a result of change of control A large block of shares may be held in a few hands for special reasons, these reasons may cease to exist, and it is desired to dispose of the holding A recent example is the Boots Pure Drug Co , Ltd The controlling interest was held by an American concern The Americans decided to sell An English group bought the shares, obtained permission to deal in them, and gradually disposed of them

through the Stock Exchange There are many forms of enterprise that have no immediate public appeal A group finances such companies in their early stages When the possibilities of the company are demonstrated, permission to deal is sought The companies concerned are usually of a special type Mining ventures, for instance, are often financed in this way About 1926, the sugar-beet factory was introduced to this country Sugar-beet flotations were unpopular, and if public issues had been made, their success would have been problematical The capital for erection of the plant and working expenses was supplied by the contractor who built the factory, the engineering firm who supplied the machinery, the sugar brokers who had an understanding that they would dispose of the output, and, to a small extent, the farmers whose beet would be used as raw material When the factory was built and profits were visible, a Prospectus "for information only" was published, and a quotation for the shares obtained Contractors, engineers, and brokers could then turn their holdings into cash

Abuses of share introductions, 1927–29

In 1927 and 1928, however, these share introductions were much abused As the Prospectus "for information only" did not require to make all the disclosures necessary in the Prospectus inviting the public to subscribe for shares, many not too reputable promoters saw in it a convenient method of foisting doubtful companies on to the public The whole apparatus of dummy companies and fake underwriting was brought into play Allotment lists submitted to the Committee were in some cases hardly worth the paper they were written on The allottees had no intention of paying for their shares Their names were used merely for the purpose of obtaining permission to deal To cope with this situation, which was a patent abuse of the market

machinery provided by the Stock Exchange, the new rules make the particulars to be advertised in the case of an introduction even more stringent than those required by the public Prospectus The new rules relating to underwriting are as follows—

Appendix 34B I

When a Prospectus has not been publicly advertised

Rules and Regulations of the Stock Exchange, 1931 Appendix 34B I

In the case of a Company (other than a Company incorporated by Special Act of Parliament) (*a*) no part of whose Share or Loan Capital is already dealt in or quoted on The Stock Exchange, and (*b*) whose Annual Accounts for at least two years have not been made up and audited, the statement required to be advertised by Appendix 34B must contain the following information—

(9) In the case of Share or Loan Capital issued or agreed to be issued for cash, the price and terms upon which the same has been or is to be issued and (if not already fully paid) the dates when instalments are payable with the amount of all calls or instalments in arrear

(16) Particulars of any commissions, discounts, brokerages or other special terms granted to any persons in connection with the issue or sale of any of the Share or Loan Capital of the Company

(17) A statement of the issued Share Capital of any Company acting as Promoter or principal Underwriter, the amount paid up thereon, the date of its incorporation, the names of its Directors, Bankers, and Auditors, and such other particulars as the Committee think necessary in connection therewith, unless particulars of such Company are contained in the issue of the "Stock Exchange Official Intelligence" current at the date of the publication of this advertisement

(19) Particulars of any of the Share or Loan Capital of the Company which is under option, or agreed to be put under option, with the price and term of the option and consideration for which the option was granted

(22) A statement certified by the Company's Auditors as to the periods (if any) for which the Company's accounts have been made up and audited and *particulars of the Share or Loan Capital subscribed and the cash actually received by the Company in connection therewith*, also particulars of all dividends paid and amounts carried forward and carried or proposed to be carried to reserve out of the profits of any such periods as shown in the accounts submitted to the Shareholders or in the Directors' Reports attached to the Balance Sheet under Section 123 (2) of the Companies Act, 1929

In the case of a company whose annual accounts for at least two years have been made up and audited, the Rules (App 34B II) are only slightly modified The particulars required need then only refer to transactions that have taken place within a reasonable time, usually two years, before permission to deal is sought

The new rules are so strict that they have caused underwriting to be the rule rather than the exception in "introductions" If the stockbroking firm or other organization placing the issue buys the shares outright, the company has no need to worry If this is not done, however, the company usually insists on the guarantee provided by underwriting Attention should be directed especially to Rules 17 and 22 Full particulars of the capital, history, and officials of the Main Underwriters are to be given, and the company's auditors must certify the capital subscribed and the cash actually received by the company in connection therewith These two rules have been very effective, and have done more than anything else to restrict undesirable "introductions" The Share and Loan Department can now see at a glance if the introduction is merely a promotion swindle with Underwriting Agreements that are valueless and with allotments to individuals or

companies who have no intention of paying for the shares until they are marketed

In 1932, a new rule was made giving the Committee power to suspend dealings altogether in the case of serious default by Underwriters— Rule 159 3 (1932)

> 159 (3) In addition to the powers contained in Rule 164 (2) and (3) the Committee may withdraw or suspend the record, but order that bargains be marked, or withdraw or suspend Permission to Deal in any security for any cause and in particular in the case of a Company which fails to publish a Statutory or Annual Report within the prescribed period or in the case of serious default by Underwriters or sub-underwriters in meeting their commitments

The Committee has been wise in tightening up its regulations in order to give the public greater protection In fact, it has gone far beyond mere changes in the written rules

Responsibility of the Committee of the Stock Exchange

Every application for permission to deal is now considered on its merits The Committee may make special conditions in connection with vendors' shares, in the case of a company formed to exploit a new and untried process or patent, it may postpone dealing facilities until the company's first annual accounts have been published, and so on If the Committee has reason to believe that dealing facilities are being improperly used, it may suspend the marking of bargains and so deprive the manipulator of his principal bait—the publicity attaching to the official record of dealings The Committee is beginning to realize not only the great power it possesses, under modern conditions of finance and industry, in its discretion to grant the privilege of dealing facilities, but also the responsibility inherent in that power It is no longer just a private

body responsible to its electors, it is a great institution with responsibilities to the public In the past two or three years it must be said that it has shown a real determination to check financial abuses that had previously flourished

The investor does not expect the Stock Exchange to protect him against the ordinary risks inseparable from investment, but he is beginning to hope that the aim of the Committee may not only be to enable the public to buy and sell stocks and shares, but to do all in its power to ensure that only the securities of reasonably sound concerns with at least prima facie possibilities of success shall enjoy the dealing facilities that it affords The Committee has done a great deal to stop underwriting abuses It has provided against much that the Companies Act, 1929, left untouched If it maintains its determination to withhold permission to deal when it is not satisfied that underwriting obligations have been fulfilled, it will act as a great safeguard to the investor Under these circumstances Main Underwriters and issuing houses will be compelled to see that the Underwriting Agreement is a true guarantee contract

CHAPTER XIV

THE MACMILLAN COMMITTEE

THE Committee on Finance and Industry, usually known as the Macmillan Committee, was appointed on 5th November, 1929 The Minute of Appointment read—

> The Chancellor of the Exchequer states to the Board that he proposes to appoint a Committee to inquire into banking, finance, and credit, paying regard to the factors both internal and international which govern their operation, and to make recommendations calculated to enable these agencies to promote the development of trade and commerce and the employment of labour

The Committee's recommendations relating to the capital market Concentration on the Issuing House

One of the main causes that led to the formation of the Committee was the defectiveness of the capital market for the purposes of home industry The Committee was one of the most authoritative that has ever sat, and its proposals relating to the capital market for home investment deserve close attention They form the Committee's remedy for many of the evils that have beset us since the War These proposals were as follows—

> 397 Coming back now to the more general question of the relations between finance and industry, and in particular to the provision of long-dated capital, we believe that there is substance in the view that the British financial organization concentrated in the City of London might with advantage be more closely co-ordinated with British industry, particularly large-scale industry, than is now the case, and that in some respects the City is more highly organized to provide capital to foreign countries than to British industry We believe this to be due in

part to the historical organization of British industry and to the fact that industry, having grown up on strongly individualistic lines, has been anxious to steer clear of anything which might savour of banking control or even interference, this attitude coinciding with the views which prevail in this country as to the province of sound banking Nevertheless a further development of our financial organization is possible, which would be distinctly beneficial and need not be inconsistent with these traditions

398 We are bound to point out, however, that unless British industry can at any rate be reasonably assured of normal profits no development such as we suggest has any chance of success No institution acting as an intermediary between industry and investor can possibly succeed unless the securities which it induces the latter to buy prove to be sound and remunerative Any concern devoting itself to industrial financing faces peculiar difficulties, for it must have a considerable capital and yet it is without a "bread and butter" business such as ordinary deposit banking or acceptance business provides

399 The functions which should be performed by such a concern may be summarized as follows Acting as financial advisers to existing industrial companies, advising in particular as to the provision of permanent capital, its amounts and types, securing the underwriting of and issuing the company's securities to the public and, if necessary, assisting previously in arranging for the provision of temporary finance in anticipation of an issue, assisting in financing long contracts at home and abroad, or new developments of an existing company, or founding companies for entirely new enterprises, acting as intermediaries and financial advisers in the case of mergers or in the case of negotiations with corresponding international groups, and generally being free to carry out all types of financing business

400 These are functions which are often difficult,

which entail considerable risks and which may involve the temporary locking-up of large sums

Such a concern must—

(*a*) be provided with a substantial capital where it is a case of financing large contracts for periods up to five years, it might be able to supplement its resources by the issue of its own short-term notes,

(*b*) be able to rely on the co-operation of existing institutions with large monetary resources in the making of temporary advances otherwise it might either be unable to carry out its functions or its capital might have to be too big for it to earn satisfactory dividends,

(*c*) build up a competent and expert staff, establish gradual connections with industry, and instil confidence in its issuing ability and credit

401 We have considered whether these are functions which the big joint-stock banks might themselves carry out They have the great advantages (i) of representing such aggregations of capital and deposit resources that their financial capacity would be undoubted, (ii) of being, through their immense number of branches and through the large sums they already lend on short credit, in touch with industry in a way not possible for any one else But for various reasons we think it doubtful whether the banks can with advantage depart from their traditional banking sphere

402 For other reasons the same conclusion seems necessary as regards the great private banking houses These houses, with very few exceptions, undertake a large acceptance business involving them in a corresponding liability to the holders of their bills It has always been recognized that acceptance business necessitates the maintenance of a high degree of liquidity and is not consistent with serious liabilities in respect of industrial financing

403 While, however, we do not propose a change in the character of present banking practice, we think that the co-operation of the big banks is

required both in taking an interest in the share capital of such an institution and being ready to provide such credit facilities as the institution may require pending a public issue The best course might be if the leading private institutions and the big banks were to co-operate in creating one or more such concerns We understand that the creation of the Bankers' Industrial Development Company was due originally to the belief that help in these directions might be given to industry by the City, which was not being given We have been told, however, that the authorities of the Bank of England consider, as we do, that these are not proper permanent functions for a subsidiary of a Central Bank It would seem desirable, therefore, that the Bankers' Industrial Development Company should at a convenient stage be definitely separated from the Bank of England, have an independent existence, and rely upon its profit-making capacity as a private institution It is possible that it might form a nucleus for that closer co-operation between finance and industry which we think is required

There is no reason why the field should be limited to any one institution In fact it is too wide for that to be desirable In practice, any concern entering it might find that some specialization over one or two particular industries was desirable We must repeat, however, that the success of institutions directing themselves to the interests of British industry must depend finally on the profit-making capacity of that industry They may help by their co-operation towards that end, but industrial problems must in the main be solved by industry itself

404 It has been represented to us that great difficulty is experienced by the smaller and medium-sized businesses in raising the capital which they may from time to time require, even when the security offered is perfectly sound To provide adequate machinery for raising long-dated capital in amounts not sufficiently large for a public issue, i e , amounts ranging from small sums up to, say, £200,000

or more, always presents difficulties The expense of a public issue is too great in proportion to the capital raised, and therefore it is difficult to interest the ordinary investor by the usual method, the Investment Trust Companies do not look with any great favour on small issues which would have no free market and would require closely watching, nor can any issuing house tie up its funds in long-dated capital issues of which it cannot dispose In general, therefore, these smaller capital issues are made through brokers or through some private channel among investors in the locality where the business is situated This may often be the most satisfactory method As we do not think that they could be handled as a general rule by a large concern of the character we have outlined above, the only other alternative would be to form a company to devote itself particularly to these smaller industrial and commercial issues In addition to its ordinary capital, such a company might issue preference share capital or debentures secured on the underlying debentures or shares of the companies which it financed The risks would in this manner be spread, and the debentures of the financing company should, moreover, have a free market We see no reason why with proper management, and provided British industry in general is profitable, such a concern should not succeed We believe that it would be worth while for detailed inquiries to be made into the methods by which other countries attempt to solve this particular problem

The bank issuing house

The Committee went to the root of the problem when it concentrated on the issuing house It had noted with approval the practice of other countries where issues are mainly or wholly in the hands of the banks It recommended that this system be introduced in a modified form in England Neither the big joint-stock banks nor the great private banking houses should enter into the issue market directly, but they should co-operate in creating issuing houses The Committee

required both in taking an interest in the share capital of such an institution and being ready to provide such credit facilities as the institution may require pending a public issue The best course might be if the leading private institutions and the big banks were to co-operate in creating one or more such concerns We understand that the creation of the Bankers' Industrial Development Company was due originally to the belief that help in these directions might be given to industry by the City, which was not being given We have been told, however, that the authorities of the Bank of England consider, as we do, that these are not proper permanent functions for a subsidiary of a Central Bank It would seem desirable, therefore, that the Bankers' Industrial Development Company should at a convenient stage be definitely separated from the Bank of England, have an independent existence, and rely upon its profit-making capacity as a private institution It is possible that it might form a nucleus for that closer co-operation between finance and industry which we think is required

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considered that the Bankers' Industrial Development Company, which had recently been founded for this very purpose under the aegis of the Bank of England, would, if it were definitely separated from the Bank of England and had an independent existence as a private institution, become in time the nucleus of such issuing houses

The Bankers' Industrial Development Co , Ltd

Let us look at the history of the Bankers' Industrial Development Co , Ltd It was registered in April, 1930, and two of its main objects are investigation and advice on all financial, industrial, and economic questions The capital authorized and issued is £6,000,000 The shares are divided into two classes—45 "A" Ordinary Shares and 15 "B" Ordinary Shares each of £100,000 The "A" shareholders are the five big joint-stock banks and forty other banks One "B" Share is held by the Right Hon M C Norman and fourteen by the Securities Management Trust, Ltd , a private "Bank of England" company

The formation of the Bankers' Industrial Development Co was foreshadowed by the Right Hon J H Thomas in a speech to the Manchester Chamber of Commerce in January, 1930 He stated that, as the result of discussions he had had with financial authorities, he was able to make the following statement—

> "In considering the steps that might be taken to produce a better employment position by improving the organization and equipment of British industries, I have found that a feeling exists that manufacturers are handicapped in bringing about the necessary reorganization and re-equipment by the fact that the long-continued trade depression has pushed them to the limits of the credit which they can reasonably expect to obtain from their bankers or which the bankers can reasonably be expected to provide As

a result of consultations which I have had, I am now in a position to state that the City is deeply interested in placing industry upon a broad and sound basis and ready to support any plans that in its opinion lead to this end Those in the City who have been studying this matter are convinced that a number of our important industries must be fundamentally reorganized and modernized in order to be able to produce at prices which will enable them to compete with the world Industries which propose schemes that, in the opinion of those advising the City, conform to this requirement will receive the most sympathetic consideration and the co-operation of the City in working out plans and finding the necessary finance In the case of individual undertakings the City will be similarly ready to help, provided that the scheme under discussion fits in as part of the general plans for the industry in question as a whole and gives reasonable promise that the changes will enable the undertaking to become an effective unit in combination and co-operation with other similar undertakings"

No organization could have been formed under more powerful auspices than the Bankers' Industrial Development Co Its advent in April, 1930, was hailed in many quarters as the greatest event of the century in the relations of finance and industry In the following year it received the blessing of the powerful Macmillan Committee Men saw in it the cure for many of our present discontents It has been functioning for upwards of three years, and what has it done? Its publicly announced operations have been few and far between Only three are known In January, 1931, the Bankers' Industrial Development Co was responsible for the issue of £1,000,000 5 per cent First Mortgage Debenture Stock of the National Shipbuilders Security, Ltd In

March, 1931, it issued the Lancashire Cotton Corporation £2,000,000 6½ per cent First Mortgage Debenture Stock In December, 1932, it was the prime mover in the arrangements whereby £3,300,000 was advanced to Stewarts & Lloyds, Ltd, to finance the erection of the great new plant at Corby The Bankers' Industrial Development Co may well have performed much useful service behind the scenes, but, so far as the public know, it has only been actively concerned in three schemes, and these have been rationalization schemes No indication has been given that it intends to enter the issuing market in any other way

Advantages of the bank issuing house in rationalization and in development of heavy industries abroad

There is no doubt that large-scale changes are needed to bring our basic industries to the state of high efficiency that international competition demands These industries in large measure have failed, by internal effort, to bring about the drastic changes required An external rationalizing force is apparently necessary It is hoped that the Bankers' Industrial Development Co is proving to be the external rationalizing force Some people are afraid that its mother-complex is a stultifying factor, but perhaps one day the Old Lady of Threadneedle Street will take the Macmillan Committee's advice and cut a few of the apron-strings

From another point of view, issuing houses formed on the lines of the Bankers' Industrial Development Co could be of inestimable service Industry is yearly becoming more internationalized Our great companies in the iron and steel, electrical, shipbuilding, chemical, and similar industries have to contend with American, German, and other competitors who are generally associated with and supported by powerful banking and financial groups In the development of the heavy industries abroad, a knowledge of foreign conditions, far-sighted planning and large supplies of capital will

be more and more required. The continuous co-operation of powerful banking and financial houses like the Bankers' Industrial Development Co. may well prove a necessity if our heavy industries are not going to find themselves cut out of world markets.

But all this is rather away from the situation we have been discussing in this book. The troubles of the past few years with which we have been concerned have related not so much to the financing of the great basic industries as to the flotation of new companies and issues on behalf of the medium and smaller-sized companies.

If the extension of the activities of the Bankers' Industrial Development Co. to all industrial issues recommended by the Macmillan Committee became a reality, it might solve all our difficulties. It may be a goal at which to aim, but there are practical obstacles in the way of its accomplishment. The idea is alien to the spirit and development of both British banking and British industry. But it is sometimes not only prudent but vital to adopt a revolutionary idea. The British system has proved inadequate to cope with post-war needs and conditions. The large organizations of railways, oil, iron and steel, and so on, make for technical efficiency, and are clearly what modern industrial methods require, but they do not form the whole of our industrial economy. If British industry is to proceed by way of increased large-scale development, of still greater mass production and mass distribution, the bank-issuing house may be a necessity. If, on the other hand, the future of England is also going to lie along the lines of increased specialization, of semi-luxury trades, of using our great reservoir of skilled labour for the development of the scientific, the intricate, the complex and the new, it is highly probable

that the bank-issuing house will not be sufficiently flexible and enterprising

Disadvantage of bank-issuing house

We have to take into account the nature of our big joint-stock banks They themselves are the results of great amalgamations of banking interests all over the country There is centralization of control in London There is a tendency for promotion to be governed not so much by energy and efficiency as by a history of no mistakes In the future it is the "safe" man who is going to reach the top Size is becoming something of an obsession The young or vigorously growing trade or industry does not receive the support it used to get from the independent bank or from the branch bank manager in the days when he had greater power On the other hand, the large combine rarely appeals in vain "Look at the size of their current account," says the Controller at Head Office, "there is usually £400,000 at their credit Of course we can give them the loan they ask" He sometimes does not pause to reflect that £400,000 may represent a bare two or three days' wages of the concern These tendencies are the obverse of the medal, the shadow of our banks' quality If the big banks formed and controlled issuing houses for general purposes, such factors, unless great care were exercised, might cause the new institutions to have a regrettable lack of elasticity

There is one direction, however, where any disadvantages of the bank-issuing house would be far outweighed by its advantages Paragraph 404 of the Macmillan Report, quoted on pages 194 and 195 above, referred to the special case of the small company that desires to raise capital but cannot afford the expense of an issue on the usual lines The Macmillan Committee recommended the formation of a Finance Company that would devote itself particularly to the small

industrial and commercial issue The method recommended was that this institution should issue preference share capital or debentures, secured on the underlying debentures or shares of the companies which it financed The shares and debentures of the Finance Company would, of course, have a free market There is no doubt that one of the greatest gaps in the English capital market has been caused by the absence of regular machinery to provide long-term finance for the small business The methods of share "introductions" or local issues so far used have obvious limitations The formation of one or two companies on the lines suggested by the Macmillan Report would fill a crying need It is believed that the Bank of England, in conjunction with certain of the big banks, has plans well advanced to form one or perhaps more of such institutions early in the present year

We have built up a wonderful, perhaps an impregnable, deposit banking system that is the admiration of the world As an external rationalizing force to our basic industries, as the handmaiden of our heavy trades in their developments abroad, and as the provider of capital for the small company, this system can perform an urgently needed service It is open to doubt if it can perform a similar service if it enters, however indirectly, the general field of company formation and issuing

CHAPTER XV

CONCLUSION

The problem restated

No matter what the eventual development of our capital market may be, industrial issues are to-day, and probably will be for some time to come, in the hands of a considerable number of issuing houses of varying size, importance, and repute This system gave rise to abuses in the active years of 1926 to 1929 For the sake of the good name of English finance, these abuses must not occur again

When they are analysed, they are found in great measure to centre round the guarantee obligation of the issuing house The economic function of an issuing house, as the English form of intermediate organization between the investor and industry, is to investigate industry's demand for capital, present it as a claim, supported by the issuing house's own guarantee, to the public, and so make it effective In other countries, where issues are in the hands of the banks, this guarantee is provided by the banks In this country, the financial side of the guarantee is provided by the Underwriters

Remedy of the Companies Act, 1929

We have seen that certain important steps have been taken to prevent a recurrence of the ills that lately afflicted us The Companies Act, 1929, sets out to provide that a company must not go to allotment until sufficient capital has been subscribed to purchase the assets that are being taken over by the Company, to pay all preliminary expenses, and to give adequate working capital The Act, however, by the proviso made after long deliberation, that cheques accepted by the directors in good faith in payment of the sums

due on application and allotment are to be considered as cash in the hands of the company for the purposes of allotment, presents a loophole for the continuance of certain of the worst practices of 1926–29

Remedy of the Stock Exchange

The Companies Act, 1929, takes us only a certain way The Stock Exchange has gone further Now that there is full disclosure to the Committee of the Main Underwriting Agreement and the Sub-underwriting Letter, and that a certified statement of Capital Receipts must be furnished, the unscrupulous promoter or Underwriter may be hit in his most vulnerable spot But the measures taken both by the Law and the Stock Exchange are rather in the nature of action after the event They will undoubtedly prevent many abuses because of the consequences that will, or may, ensue if the guarantee obligation of the issuing house is not fulfilled They do not, however, tackle the problem directly

Remedy of the Macmillan Committee

The remedy proposed by the Macmillan Committee is the development in a modified form of the bank-issuing house For the reorganization and rationalization of our basic industries, its application may be necessary and vital, but for the general run of industrial issues it does not seem to offer a practical solution under present conditions Even in the latter case, its eventual adoption may be forced on us one day, but there is no indication that that day is near at hand

Other proposed remedies

There have been other suggestions—the constitution of a permanent Shareholders' Protection Committee representing official bodies such as the Board of Trade, the Stock Exchange, and certain professional organizations, the formation of a Joint Committee of representatives of the banks and of the Stock Exchange to which all prospectuses of limited companies should

be submitted, the setting up of an Advisory Panel of bankers, accountants, and valuers, and so on

There is much that is sound in these proposals, but none of them has advanced beyond the stage of discussion A Shareholders' Protection Association was certainly founded in October, 1932 It has done valuable work and issued its first report, but membership is confined to shareholders and debenture holders in public and private companies, including organizations registered under the Industrial and Provident Societies Acts In other words, it is an organization of the investor himself

Conflicting views of City solicitors

Several large firms of City solicitors made it known some time ago that they will not advise in cases where the capital of the issuing house or Main Underwriters is less than £50,000 An issuing house should obviously have a substantial capital or at least have command of large resources Other firms of solicitors, however, point out that the success of an issuing house depends on its reputation, its skill, and the standing of the sub-underwriters on its books, rather than on the size of its capital They state that they have acted for years for issuing houses with a capital of £10,000 or £20,000, and that these issuing houses have scrupulously fulfilled every obligation There is, therefore, no unanimity among solicitors on the attitude that they should adopt in regard to the size of an issuing house

The problem should be tackled at its heart—the underwriting contract

Something more must be done The guarantee problem should be tackled at its heart—the underwriting contract It is extraordinary how seldom the Main Underwriting Agreement was mentioned in all the comment in the Press, in Parliament, from the Bench, among professional and semi-professional bodies, on the partial breakdown of our capital market in 1927–29 The key position of the underwriting contract has been

imperfectly understood The secrecy that has surrounded the Main Underwriting Agreement has resulted in its terms being only vaguely known

To prevent a recurrence of past abuses and to make the measures taken by Parliament and the Stock Exchange effective, we submit that the following three reforms should be instituted—

1 The Main Underwriting Agreement should in all cases be a full guarantee contract

2 Sub-underwriters should be approved, not by the Directors of the Company on whose behalf the issue is being made, but by the bank named in the Prospectus

3 Both the Main Underwriting Agreement and the sub-underwriting letter should be standardized

1 The Main Underwriting Agreement should in all cases be a full guarantee contract

When underwriting was recognized by the Companies Act, 1900, the situation contemplated was one where all guarantee contracts were made directly between the Company and the Underwriters As issues became larger and more frequent, the rise of the sub-underwriter, under the conditions of the English capital market, was logical and necessary He is a corollary of the organization of underwriting The sub-underwriter was not, however, a party to the guarantee contract between the Main Underwriter and the Company Until 1920 the Main Underwriter, on the whole, accepted responsibility for the sub-underwriter, but after 1920 we have seen that there was a gradual deterioration of the provisions of the Main Underwriting Agreement In 1927 and 1928 a position was finally reached that in many cases Main Underwriters had succeeded in contracting out to sub-underwriters the

whole of their guarantee obligation The usual paragraph in the Main Agreement ran that, when the sub-underwriters had been approved by the Company, the guarantee obligation of the Main Underwriters ceased The directors of a new company are as a rule unversed in the intricacies of company flotation Certain of them are often nominees of the issuing house At the time when the Company is most in need of their protection, they either have not the knowledge or are not in a position to give it In many cases the approval of sub-underwriters by a Board has been the merest formality The Company has been left with the shell of a guarantee agreement This shell was solemnly exhibited in the Prospectus as the assurance to the investor that, no matter what the nature of the response of the public to the issue might be, the Company was guaranteed its capital In fact, the guarantee was non-existent The Main Agreement had ceased to be a guarantee contract It had become a mere agreement to procure sub-underwriters, between whom and the Company there was no contract

Issuing houses as the organizers of underwriting thus escaped their main responsibility They could become issuing machines and nothing more Keen and eager, if unscrupulous, minds were quick to seize the opportunity thus afforded them Numbers of new issuing houses and underwriting companies sprang up to earn the easy commissions that were now possible Sub-underwriters were often men of straw If they were responsible persons, they could be protected by devices such as applications for shares by dummy companies sufficient to relieve them of their obligations And we had the ramp of 1927–29

These practices will be stopped if the Main Underwriting Agreement is made a full guarantee contract

There can be as many sub-underwriters as the issuing house desires From the Company's point of view in many cases, the more responsible sub-underwriters there are, the better But the Main Underwriters must be responsible for their sub-underwriters If the latter default, the Company should always be in a position to look to the Main Underwriters to make the default good Underwriting commission should not be payable until at least several days have elapsed after all moneys due on application and allotment from Underwriters and sub-underwriters have been received by the Company There is to be no question of cheques in the hands of the Company being regarded as cash Cheques from Underwriters and sub-underwriters must have been cleared and met before any commission is payable

At present, under the heading of contracts on the last page of a Prospectus, there usually appears the sentence "Various sub-underwriting contracts have been entered into, to which the Company is not a party" The issuing house that first sets the precedent of making this sentence read "Various sub-underwriting contracts have been entered into, to which the Company is not a party, but fulfilment of these sub-underwriting contracts is guaranteed by contract No — above, between and the Company," will be entitled to a high place in any future history of the English capital market

2 Sub-underwriters should be approved by the Company's bankers

Sub-underwriting has become an essential part of issue machinery In this country, where issuing houses are specialized concerns not as a rule of huge financial resources, it is an obvious necessity that they reinsure

a substantial part of their guarantee obligation It is correspondingly important to the Company that the sub-underwriters be responsible and able to meet their engagements If the public fail to respond to an issue, the Company looks to the Main Underwriters in terms of the guarantee contract, but it knows that the Main Underwriters in turn rely in large measure on the sub-underwriters From the first beginnings of sub-underwriting, therefore, Companies have rightly insisted that sub-underwriters must be approved, but, as we have seen, the almost invariable provision in the Main Agreement is that they be approved by the Company itself We have already given the reasons for our belief that this is a serious defect in current practice The responsibility of approving sub-underwriters should be taken away from the directors of the new company and given to the Bank named in the Prospectus

The position of the Bank in a Prospectus has been a source of much misapprehension among investors The energies of every promoter are directed in the first place to secure a good "front page" When an investor picks up a Prospectus, his attention is naturally focussed on the first page, and it is not too much to say that the success or failure of an issue largely depends on the nature of this page Its lay-out has been carefully worked out over a period of many years to give it the maximum psychological appeal The great banks are known and respected by everyone The name of the Company's Bank is always mentioned in a prominent position on the front page, as a rule immediately after the names of the directors, and before the names of the solicitors, brokers, auditors, secretary, and registrars In large bold type in the centre of the page, there is also a statement that " Bank, Ltd are authorized as Bankers to the Company to receive

applications for shares of each, payable as follows" The investor has too often assumed, on seeing the name of a well-known bank thus emphasized in the Prospectus, that the bank in some way vouches for the issue This is not so, however The banks do not regard themselves as in any way responsible for an issue beyond seeing that the Prospectus complies generally with the law, and that the issue, on the face of it, is respectable Since 1929, however, one or two of the banks have, when asked, and sometimes without being asked, made inquiries, and satisfied themselves that the sub-underwriters were responsible for their engagements This should become general practice The banks have unusual facilities for making inquiries It would be a simple matter of routine for them to verify the standing and responsibility of any list of sub-underwriters The majority of the sub-underwriters are usually strangers to the directors of a new company, and in any case the Board would place themselves in an invidious position in relation to the issuing house if they gave instructions that the references of the sub-underwriters were to be taken up The great banks, however, could very easily make it a condition of their names going on a prospectus, that they must be satisfied as to the standing of the sub-underwriters By so doing, they would render a great public service, a service that they owe to the general body of investors The day it became known that the big banks had made this rule, the inclusion, for instance, in lists of sub-underwriters of men of straw for large blocks of shares would stop, and the whole fabric of underwriting would be strengthened We have, therefore, suggested in Chapter VI, that the first paragraph proper of the Main Underwriting Agreement should read—

For the consideration hereinafter stated and subject as hereinafter mentioned, the Underwriters hereby underwrite the subscription of
of the said shares of the Company on the terms of the said Prospectus, and shall lodge with the
Bank as the Company's Bankers, before the day on which the said Prospectus is first advertised, application by themselves and *by sub-underwriters approved by the said Bankers*, for all the shares hereby underwritten, etc

3 The Underwriting Contract should be standardized

The problem of underwriting is, in some respects, like one of these problems with which the psychoanalyst deals The cure may be effected merely by bringing it out into the open, by discussing it, by appreciating its significance in the order of our financial economy When the veil of secrecy that has surrounded it is taken away, and its essential principles are grasped, it is seen to be a simple contract There is substantial agreement in the underwriting practice of the best issuing houses and the best City solicitors It would only be a tiny step further to obtain agreement on a standard form both of Main Underwriting Contract and of Sub-underwriting Letter In Chapters VI and VIII there is given a type of each that conforms to good practice They deal with the share issue Debentures, Offers for Sale, Offers on a Reconstruction, and Offers to Shareholders used to present problems of their own The principles of such underwriting contracts were always the same as in the ordinary share issue, and, since the 1929 Act, there are few differences in practice Any standard forms that might be adopted could very easily allow for the minor variations from the share issue that are left

There never has been a more opportune moment for the adoption of a uniform Underwriting Agreement The development of the contract along the lines of irrevocability, power of attorney, certainty, precision, has perhaps reached finality The dangers of the contemporaneous development of the contracting out of the guarantee obligation to sub-underwriters are appreciated, and we have suffered so severely from their effects that there is universal consent that the practice must be stopped The best issuing houses have already tackled the problem in their own way We suggest that if a few of the more prominent houses called a conference of London issuing houses to consider the matter, a basis of general agreement could be reached without difficulty The publication thereafter of standard forms of Main Underwriting Agreement and Sub-underwriting Letter would go far to allay the uneasiness that still exists in the minds of investors

There has been a lull in the business of issuing since the close of 1929 The troubles of the preceding years had shaken the confidence of investors Then came the world crisis We are slowly emerging from the depression Notwithstanding our great burdens and our heavy losses, this country has still very remarkable resources of capital, skill, and enterprise Above all, its credit has been substantially maintained Confidence is beginning to re-establish itself, and conditions soon may favour another time of industrial activity In the post-war period our capital market was the weakest link in our financial economy When the next boom comes we shall see how far it has strengthened itself in the interim One thing is certain The scandals of 1927–29 must not be allowed to recur We have seen that in large measure they centred round the collapse of the guarantee obligation of the issuing house

If the guarantee supplied by underwriting is made an effective guarantee, the measures lately taken by the Legislature and the Stock Exchange to cleanse company finance should make the next period of capital activity more of a credit to the City of London

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